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THESIS

THE ECONOMIC IMPLICATIONS OF KOREAN UNIFICATION

by

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THE ECONOMIC IMPLICATIONS OF KOREAN UNIFICATION

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ABSTRACT

A major area of concern for Korean unification is the immense cost it will impose on South Korea. To lessen this burden, South Korea will need to initiate policy reforms that can ease the financial stress and repercussions of unification and create an integrated economic community with North Korea. At the same time, North Korea will need to create an environment that is conducive to economic integration by accepting and adopting reform measures that can build the foundation for a market economy. The two largest factors to any economic reform strategy in North Korea would be to overcome the changes to the political-belief system that drives the current economy and the strong link between the state and masses. A policy of engagement will create an environment in which inter-Korean dialogue and mutual cooperation could lead to a transformed, opened North Korea. The unification of Germany and Yemen offer pros and cons as well as similarities and dissimilarities to Korea to form certain conclusions, predictions, and prescriptions. The case studies of China and Vietnam provide a detailed analysis of planned economies transitioning to market economies. From these case studies, several conclusions are drawn regarding the implications of economic unification.

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EXECUTIVE SUMMARY

The economic implications of Korean unification are proportionally one of the largest obstacles, question marks, and areas of concern. Korean unification will not be cheap nor will it be seamless. The World Bank has estimated that the cost of Korean unification could amount to several trillion dollars. To alleviate the immense cost involved in unification and to avoid the sole economic burden, South Korea will need to initiate policy reforms that can ease the financial stress and repercussions of unification and create an integrated economic community with North Korea. At the same time, North Korea will need to create an environment that is conducive to economic integration by accepting and adopting reform measures that can build the foundation for a market economy. The formula for success in both the South and North is intricate and lengthy, but in each case the importance of the situation facing the two Koreas requires immediate and essential economic policy reform.

Given the complex situation involving the Korean peninsula, South Korea has three choices in terms of policy direction toward North Korea: a policy of containment that could stir up a confrontation by exploiting mutual distrust and touching off an arms race; a policy of benign neglect that could endanger the nation's security in the absence of serious efforts to engage North Korea in a number of issue areas; and a policy of engagement that will create an environment in which inter-Korean dialogue and mutual cooperation could lead to a transformed, opened North Korea.

The policy of engagement, according to South Korean President Kim Dae-jung, “is the only practical choice and offers the best chance to fulfill the goal of the South Korean people – the maintenance of peace on the Korean Peninsula.” A series of events, including the historic inter-Korean summit during June 2000, follow-up meetings of officials, and the reunions of separated families, were made possible due to the success of the engagement policy. As a result of engagement, the previously unimaginable dialogue between North and South Korea was sustained, despite worldwide tension caused by the September 2001 terrorist attacks on the United States. As an avenue of the engagement policy, South Korea should be able to conduct joint and mutual economic activities and

induce a flow of foreign investment into North Korea to help begin its economic recovery. With the appropriate policy already in place, both Koreas have the right tools to establish the kind of peaceful and conducive atmosphere it needs to make economic integration a success.

In order to begin the successful economic integration of the Korean peninsula, certain economic reforms in North Korea would have to be implemented. The transformation effort would have to involve fundamental reforms of the economic planning mechanism and the introduction of market principles in decision-making, production, and allocation of resources. As such, the object of economic reform in North Korea would be to replace the socialist pattern of a planned economy with a market-oriented economy. The challenge to any such reform is, however, the complex nature and interconnected institutions of the industrial complex. The two largest factors to any economic reform strategy in North Korea would be to overcome the changes to the political-belief system that drives the current economy and the strong link between the state and masses. First, economic liberalization would mean the nearly complete dissolution of *Juche*. A market economy stands for everything that *Juche* preaches against, including a socialist state structure. Secondly, the state is intimately involved in every decision regarding the economy, even at the lowest level and regardless of scope. Economic liberalization would cause the state to relinquish its power and authority to external market forces.

A slow, careful approach to reducing tension and increasing ties between the two Koreas is needed to provide time for a more complete integration of the two societies prior to full unification. Such an approach could mitigate the impact of some of the more socially disruptive and economically costly aspects of the unification process. After unification, Korea will be preoccupied internally. All available capital will be channeled into reconstructing the threadbare North. The daunting task of infrastructure investment and industry retooling will take years. As the cases of Yemen and Germany show, a more deliberate economic union and integration prior to unification will ease many of these burdens.

China and Vietnam are examples of gradualist economic reform. Because of the size and scope of the industrial sectors in each country, the reform strategy has thus far been successful, especially initially. Both countries were largely agrarian with very little heavy industry. Thus, the growth and increased standard of living that resulted from initial agricultural reforms provided a cushion to absorb some of the political turmoil of reform and in addition countered the erosion of political legitimacy. In North Korea, because of its centrally planned and heavily industrialized economy, the gradualist approach would be an unsuccessful option. However, the reforms in China do provide a good analysis of what North Korea potentially faces.

The gradual and calculated economic integration of the Korean peninsula will be a long-term project that will require serious patience and perseverance. A continued separate economic future will only widen the gap between the North and the South and further increase the possibility of catastrophe. Any delay in economic integration will also continue to increase the costs of unification, creating enlarged burdens for the South as the North further continues its economic decline. Thus, building trust gradually through economic and humanitarian exchanges is a means for advancing both the short and long-term goals of peaceful coexistence and eventual unification.

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I. INTRODUCTION

“The question is not will [North Korea] disintegrate, but rather how it will disintegrate, by implosion or explosion and when.”¹

-General Gary E. Luck, the former commander of U.S. and U.N. forces in South Korea.

A conclusion can be drawn from recent academic studies, detailed research, and expert opinion: Korean unification is not a matter of if it will occur but rather of when and how. The immediate prospects for unification seem unrealistic, but the inevitability of change is certain. The most popular and well-supported argument conveys that the North Korean regime, faced with harsh domestic conditions and intense international pressure, sits on the verge of collapse. Only time will tell if impending failure brings the communist North² to the negotiating table or creates the unintended consequence of chaos, or even the more unnecessary result, war. Nevertheless, a unified Korean peninsula is a realistic expectation, regardless of the means by which the two Koreas unite.

The economic implications of Korean unification are proportionally one of the largest obstacles, question marks, and areas of concern. Korean unification will not be cheap nor will it be seamless. The World Bank has estimated that the cost of Korean unification could amount to several trillion dollars.³ To alleviate the immense cost involved in unification and to avoid the sole economic burden, South Korea⁴ will need to initiate policy reforms that can ease the financial stress and repercussions of unification and create an integrated economic community with North Korea. At the same time, North Korea will need to create an environment that is conducive to economic integration by accepting and adopting reform measures that can build the foundation for a market economy. The formula for success in both the South and North is intricate and lengthy, but in each case the importance of the situation facing the two Koreas requires immediate and essential economic policy reform.

¹ Testimony before the House Committee on National Security, Washington, D.C., March 28, 1996.

² North Korea or Democratic People's Republic of Korea or DPRK.

³ All monetary figures are given in U.S. dollar amounts. Thomas Andersson and Carl Dahlman, Ed., *Korea the Knowledge-Based Economy: Making the Transition* (Washington, DC: World Bank Institute, 2000), 27.

⁴ South Korea or Republic of Korea or ROK.

A. IMPLICATIONS FOR SOUTH KOREA

Given the complex situation involving the Korean peninsula, South Korea has three choices in terms of policy direction toward North Korea: a policy of containment that could stir up a confrontation by exploiting mutual distrust and touching off an arms race; a policy of benign neglect that could endanger the nation's security in the absence of serious efforts to engage North Korea in a number of issue areas; and a policy of engagement that will create an environment in which inter-Korean dialogue and mutual cooperation could lead to a transformed, opened North Korea.⁵

The policy of engagement, according to South Korean President Kim Dae-jung, “is the only practical choice and offers the best chance to fulfill the goal of the South Korean people – the maintenance of peace on the Korean Peninsula.”⁶ A series of events, including the historic inter-Korean summit during June 2000, follow-up meetings of officials, and the reunions of separated families, were made possible due to the success of the engagement policy. As a result of engagement, the previously unimaginable dialogue between North and South Korea was sustained, despite worldwide tension caused by the September 2001 terrorist attacks on the United States. As an avenue of the engagement policy, South Korea should be able to conduct joint and mutual economic activities and induce a flow of foreign investment into North Korea to help begin its economic recovery. With the appropriate policy already in place, both Koreas have the right tools to establish the kind of peaceful and conducive atmosphere it needs to make economic integration a success.

B. IMPLICATIONS FOR NORTH KOREA

In order to begin the successful economic integration of the Korean peninsula, certain economic reforms in North Korea would have to be implemented. The transformation effort would have to involve fundamental reforms of the economic planning mechanism and the introduction of market principles in decision-making, production, and allocation of resources. As such, the object of economic reform in North

⁵ Kim Jung Min, “Clutching at Straws”, *Economic Monitor: South Korea*, 18 Oct 2001.

⁶ “The Korean Economy and Economic Policy”, *FAO APFSOS Working Paper NO. 6-1.1* (Dec 2001)
<http://www.fao.org/montes/fon/fons/outlook/asia/06/APFSOS02.htm>

Korea would be to replace the socialist pattern of a planned economy with a market-oriented economy. The challenge to any such reform is, however, the complex nature and interconnected institutions of the industrial complex. The two largest factors to any economic reform strategy in North Korea would be to overcome the changes to the political-belief system that drives the current economy and the strong link between the state and masses. First, economic liberalization would mean the nearly complete dissolution of *Juche*.⁷ A market economy stands for everything that *Juche* preaches against, including a socialist state structure. Secondly, the state is intimately involved in every decision regarding the economy, even at the lowest level and regardless of scope. Economic liberalization would cause the state to relinquish its power and authority to external market forces.⁸

In order to better determine a plan for future economic integration, an analysis is required of both the North Korean and South Korean economies. Using the case studies of the unification of Germany and Yemen, the pros and cons as well as similarities and dissimilarities to Korea will form certain conclusions, predictions, and prescriptions with regard to the economic implications of Korean unification. Two additional case studies, China and Vietnam, provide a detailed analysis of planned economies transitioning to market economies. In both cases, the state maintained its communist facade but adopted economic reforms that transitioned each economy into market systems. China and Vietnam are realistic examples for Korea because they are Asian, and in each case the existing regime maintained political power. From these analyses case studies, several conclusions are drawn regarding the implications of economic unification.

⁷ William J. Taylor, "The Korean Peninsula at the Crossroads: Which Way?" in *The Two Koreas And The United States: Issues of Peace, Security, and Economic Cooperation*. Ed. Wonmo Dong (New York: M. E. Sharpe, 2000), 222.

⁸ Taylor, 223.

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II. COMPARISON OF ECONOMIC SYSTEMS AND POLICIES

Upon formal division in 1946, the difference between the economic potential of North and South Korea was striking. The 38th parallel seemed to divide the peninsula in a manner most advantageous to the North. The vast majority of the raw materials were located in the North, along with about 90 percent of Korea's energy generating capacity.⁹ The majority of the economic infrastructure created by the Japanese during the occupation period was located in the North. Although heavily damaged in the Korean War, the North had a strong foundation on which to build. Economic and technical support from the PRC and USSR also helped quickly rebuild the economy.

Nevertheless, two thirds of the total population lived in the predominantly agricultural South. The South had an extremely weak economy following the departure of the Japanese and did not reach a level of self-sufficiency until the late 1960s. Strained by the war effort and with little economic reform or development, South Korea subsisted on foreign aid, mostly from the United States.

Before the 1960s, Korea's economic progress contradicted common belief. The North's socialist system experienced substantial growth through the last years of the 1950s and into the 1960s. The South experienced an average annual growth rate of only 2 percent throughout the 1950s. Without aid from the United States and other allies, the South's economy would have probably produced no growth whatsoever. In this period, the North appeared as the economic model and the South as the economic failure. However, over the next thirty years crucial economic growth, technological change, and structural transformation took place, both shaping the present and impacting the future.¹⁰

A. SOUTH KOREAN ECONOMIC DEVELOPMENT

The South Korean economy suffered neglect during the tenure of President Syngman Rhee, which began in 1948. President Rhee was preoccupied with his own political stability and much less concerned with economic prosperity. His economic

⁹ James A Gregor, *Land Of The Morning Calm: Korea And American Security* (Washington, DC: Ethics and Public Policy Center, 1990), 20.

¹⁰ Gregor, 21.

policies were not well planned nor were they well implemented. Rhee's policies sought only to increase government leverage over the business sector in order to secure his power base and reduce political opposition.

The post-Korean War period in the South saw some economic growth, but not to the level that was expected. The average annual growth rate from 1953 to 1960 was 4 percent in real terms "despite the tremendous need for reconstruction and the demand for import substitution of those goods, which required only simple technology."¹¹ The economy was suffering in numerous areas, including poor management, a high inflation rate, negative real interest rates, low domestic savings, overvalued exchange rates, and large trade deficits. To stay afloat, foreign aid financed more than 70 percent of the South's total imports.¹²

Syngman Rhee's rule over the South ended abruptly in 1960. The successor government to Rhee promised reform, but it had neither the resources nor the initiative to create a stable political and economic environment. On May 16, 1961, Major General Park Chung-hee staged a military coup, gained control of the government, and enacted martial law. By October 1963, a stable environment had been created, and General Park was elected president in a national election.

1. Park Chung-hee's Revitalization

The Park era is marked by rapid industrialization and unprecedented economic growth. Behind this economic expansion was Park's goal of successful reunification of the Korean peninsula. To achieve this, Park believed that real growth and sustained development could only be accomplished by making the ROK a contributing member of the international economic community.

Park's pursuit of an export led growth strategy caused the inflated national currency to be devalued. It also encouraged domestic savings and investment. "As a consequence, between 1961 and 1964, the national currency of the ROK was devalued by

¹¹ Koo Young-nok and Suh Dae-Sook, Ed. *Korea and The United States: A Century of Cooperation* (Honolulu, HI: University of Hawaii Press, 1984), 244.

¹² Koo Young-nok and Suh Dae-Sook, 245.

almost 50 percent and interest rates on savings were doubled.”¹³ Signaling an increase in domestic saving, by 1975 investment was financed out of domestic resources, up from just 30 percent in 1962. Also, domestic savings equaled 27 percent of the GNP in 1975 compared to 3 percent in 1962. Thus, the government had reduced the amount of GNP devoted to private consumption, from 85 percent in 1962 to 65 percent in 1975, allowing the government to commit the remainder to domestic capital formation.¹⁴

Park implemented a series of five-year development plans that began in 1961. These plans sought to stimulate and sustain export growth through accelerated depreciation on fixed assets employed by the export industries, tax advantages for export companies, tariff reductions on intermediate capital goods and raw materials used in the production of export items, and discretionary access to credit as well as exchange-rate advantages for major exporting firms.¹⁵ In 1976, growth peaked at 15.5 percent. Over the fifteen-year period between 1961 and 1976 growth averaged 9.5 percent. As a result, this same period also saw the GNP increase by 400 percent.¹⁶

Table 1: GDP Growth Rates Under Park Chung-hee

Plan Period	Growth Rate
1962-1966	7.7 percent
1967-1971	11.3 percent
1972-1976	10.9 percent
1977-1981	5.8 percent
Source: Shahid Alam, 55. ¹⁷	

¹³ Song Byung-Nak, *The Rise of the Korean Economy*, Second Edition (New York: Oxford University Press, 1997), 15.

¹⁴ Song Byung-Nak, 29.

¹⁵ Bruce Cumings, *Korea's Place in the Sun: A Modern History* (New York: W.W. Norton and Company, 1997), 67.

¹⁶ Cumings, 82.

¹⁷ Shahid M Alam, *Governments and Markets in Economic Development Strategies: Lessons From Korea, Taiwan, and Japan* (New York: Praeger, 1989), 55.

Japan provided a major stimulant to the South's remarkable economic growth under Park's tenure. After the 1965 normalization of relations between South Korea and Japan, public and private Japanese investment in Korea surged, reaching \$1.2 billion by 1970, only to exceed \$3 billion by 1973.¹⁸ In only eight years, South Korea had become Japan's second largest trading partner behind only the United States.

International political currents had a huge influence on the Park's economy. After President Nixon vowed in 1969 to withdraw U.S. forces from Vietnam and reduced the number of U.S. forces in Korea from 60 thousand to 40 thousand, Park directed a large increase of investment into heavy industry. This was done particularly to create a military industrial complex to support a self-sustaining South Korean military. In 1977 President Carter sought to further reduce the number of U.S. forces in Korea. This action, although unfulfilled, created fears that the United States would not militarily aid South Korea. Thus, the Park administration committed itself to creating an industrial base sufficiently strong enough to provide for its own defense.

Combined with borrowing to support investment into heavy industry and the oil shocks of the late 1970s, foreign debt in the South increased from \$2 billion in 1970 to \$20 billion in 1979.¹⁹ In 1980, for the first time since 1961, the South recorded negative growth, with the economy falling by 5.2 percent from the previous year, creating unprecedented domestic tension complementing concerns over national security. Resistance to Park's authoritarian manner began to mount until he was assassinated in October 1979. A successor government quickly assumed power, but just as Park had done, the military staged another coup in August 1980 and General Chun Doo-hwan was elected President shortly thereafter.

2. Post-Park Transition

Severe measures that reduced inflation were imposed by President Chun, and the economy recommenced its self-sustained growth.²⁰ During the fifth plan period (1982-1986) the South grew at a rate of 7.1 percent and export expansion resumed at a

¹⁸ Ralph Clough, *East Asia and U.S. Security* (Washington, D.C.: The Brookings Institute, 1975), 165.

¹⁹ Gregor, 35.

²⁰ Sakong Il, *Korea In The World Economy* (Washington D.C.: Institute for International Economics, 1993), 44-45.

rate of over 25 percent a year by 1986.²¹ This signaled that the recession of the early 1980s was over and the ROK economy was continuing its course of expansion. Chun credited the government's commitment to advanced industrialization and ability to respond to change as the reason for continued growth.

After Chun left office in 1988 growth continued, due in large part to the continued economic development plans and the priority the government placed on it. The South grew at a rate of 7 percent during the sixth plan period (1987-1991).²² The period following the sixth economic period show the stark influence of the Cold War in the region and the effect the end of Soviet influence had on the economic parity between the two Koreas. As well, the 1988 Olympics brought newfound advantages to South Korea within the global market. In 1992, the South's GDP was \$294.5 billion and its per capita GDP was \$6,749.²³ In comparison, the North's GDP (estimated) the same year was \$21.1 billion and per capita GDP was \$943.²⁴

3. Post-Cold War Economy

From 1992 to 1997, South Korea was one of the four fast growing economies in Asia, averaging 6.6 percent GDP growth over that period.²⁵ This made it the best performing emerging market in the world. Despite its phenomenal economic success, Korea was not immune to the financial crisis that engulfed much of East and Southeast Asia. In November 1997, Korea followed Thailand and Indonesia in suffering a loss of international investors' confidence, resulting in a severe foreign exchange liquidity crisis. The Korean won lost over 50% of its value against the dollar by the end of 1997, and foreign currency reserves dropped to dangerously low levels.²⁶ In December 1997, Korea signed an enhanced \$58 billion IMF package, including loans from the IMF, World Bank, and the Asia Development Bank. Under the terms of the IMF program, Korea agreed to accelerate the opening of its financial and equity markets to foreign investment and to

²¹ Sakong II, 36.

²² Gregor, 102.

²³ Wonmo Dong, *The Two Koreas And The United States: Issues of Peace, Security, and Economic Cooperation* (New York: M. E. Sharp, 2000), 55-57.

²⁴ Dong, 59.

²⁵ Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," *Brookings Papers on Economic Activity* (October 1998), 7.

²⁶ Radelet and Sachs, 88.

reform and restructure its financial and corporate sectors to increase transparency, accountability, and efficiency.²⁷

The 1997 financial crisis exposed an array of fundamental problems, including enormous over-capacity, a near bankrupt banking sector, and mountains of private sector debt. Nonetheless, South Korea made a remarkably strong cyclical economic recovery. In doing so, the ROK has made more progress in financial and cooperate reform than any of the other countries heavily impacted by the crisis. Because of the South Korean reform effort, there has been a surge in direct foreign investment since 1998 and South Korean debt has been upgraded by foreign credit-rating agencies. A key to success has been the implementation of a significant legal structure to guide the process of economic reform. Korea's goal has been "to move from a system with a relatively high level of state guidance to a truly market-based system."²⁸

B. NORTH KOREAN ECONOMIC DISARRAY

In contrast to the South, North Korea pursued a socialist revolution under the pretense of securing a material base for the liberation of South Korea. Because the North sought development only within the framework of the concept of a limited value, the DPRK failed to take proper advantage of the economic superiority it enjoyed over the South.

1. Juche

The poor performance of the North Korean economy is attributable to the fact that private ownership of production facilities has been banned in favor of state ownership. On this basis, a planned economy was instituted in which all production, distribution, and consumption activities are undertaken only on the orders from authorities.²⁹ The DPRK initiated agrarian reforms in March 1946 during the Soviet occupation, prior to the establishment of Kim Il-sung's communist regime. In August 1946 important

²⁷ International Monetary Fund (IMF). *Country Information – Korea, Republic of*. <http://www.imf.org/external/country>.

²⁸ Lawrence B. Krause, "Asian Economic Models Reconsidered," in *The Changing Asia-Pacific Region: Strategic and Economic Issues*, Monograph Series Number 13. ed. Lee, Chae-Jin (Claremont McKenna College: Keck Center for International and Strategic Studies, 2001), 43.

²⁹ Don Oberdorfer, *The Two Koreas: A Contemporary History* (New York: Basic Books, 1997), 82.

manufacturing plants, transportation, communications, and banking facilities began to be nationalized, thus setting the foundation for public ownership of all assets.³⁰

After the Korean War, from 1953 to 1958, agriculture was collectivized and private sectors of commerce and industry were nationalized. In 1958 private ownership of all production means was eliminated in favor of overall public ownership in all economic areas. The only private production allowed was by farmers through the cultivation of the land around their homes and through other small businesses run during off-duty hours.³¹ This planned economy was relatively effective for post-war rehabilitation and early industrialization. With the progress of industrialization, however, the planned economy began to backfire. The reversal of the North's economic superiority began in the late 1960s, when the South began to take a striking lead, due in part to President Park's emphasis on economic development and the North's complete economic centralization.

The later downfall of the North's economy was rooted in this period in the relentless creation of heavy industry and the neglect of the agricultural sector. External trade was conducted nearly exclusively with other socialist states. The majority of the products traded were noncompetitive on world markets. The labored work force was heavily neglected, receiving only rationed necessities, which allowed the government to accumulate resources that would be used for investments. Each of these practices created the foundations of later economic ruin in the North.

The emphasis on heavy industry was common to most planned or economies. In the North, it was considered the source of power, as stated by Kim Il-sung. "Heavy industry constitutes the material basis for the country's political and economic independence...and is necessary to develop military strength to protect the revolutionary state against the threat of capitalist aggression."³² Massive projects centered on the heavy industries did produce impressive statistics and high visibility, similar to those experienced in China under Mao's "Great Leap Forward." However, these projects did not produce marketable products or satisfy quality and demand criteria.

³⁰ Nicholas Eberstadt, *The End of North Korea*. (St. Martins Press: New York, 1997), 7.

³¹ Oberdorfer, 64.

³² Samuel S. Kim, *Korea's Globalization* (New York: Cambridge University Press, 2000), 21.

The early stress on industrial development did not mature into balanced growth. The emphasis on heavy industry neglected consumer needs, the agricultural sector, and light industries. In 1964, only 20 percent of state investment, the highest percentage on record, was allocated to agriculture, while 60 percent was earmarked for heavy industry.³³ By 1966, the North could only meet the basic food needs of the people through strict rationing. That was also the last year the North last published data on grain production, signifying that yields were declining as a result of the low priority and investment rates in agriculture.³⁴ In 1967, the Seven Year Plan was extended to 1970, and even by then production goals were not attained.³⁵

Because of the economic stagnation in the 1960s the DPRK leadership sought drastic changes in its economic plan and modified the development strategy that had previously guided the country. In 1970, the North sought to import technologies from capitalist countries. By 1974, 60 percent of DPRK imports were from non-socialist sources, as contrasted to 11 percent in 1971, suggesting that socialist countries, especially the USSR and China, did not make advanced technologies available to other socialist countries.³⁶ This had an adverse affect on the DPRK's economic prosperity and growth.

Regardless of the al970s reforms, the North entered the 1980s with a lagging economy, barely able to provide the minimum in social services. New reforms were adopted, but they proved ineffective. In 1984, the DPRK leadership adopted regulations allowing foreign companies of any origin to enter into joint ventures.³⁷ This reform was ineffective because of the North's unattractive economic environment. Still, amidst economic ruin, the DPRK continued to dedicate as much as 20 percent of the GNP to its military.

North Korea became the first socialist country to default on its international trade debts. The first blow was the oil crisis of 1973. Because of the North's self-imposed isolation from the international market, the country was unable to sell its raw materials

³³ Gregor, 23.

³⁴ Marcus Noland, *Avoiding The Apocalypse: The Future Of The Two Koreas* (Washington, DC: Institute For International Economics, 2000), 44.

³⁵ Noland, *Avoiding The Apocalypse*, 58.

³⁶ Robert T. Oliver, *A History of the Korean People in Modern Times: 1800 to the Present* (Newark: University of Delaware Press, 1993), 111.

³⁷ Oliver, 124.

and goods on the international market to address its oil shortage. Debt continued to grow while the North's resources continued to shrink. When the burden of paying off the debts proved too difficult, the country simply defaulted. In 1987, after several attempts to negotiate a rescheduling agreement failed, the North's creditors declared the country in default.³⁸ By 1989, the North's trade debts reached \$6.78 billion.

2. The End Of The Cold War

Paradoxically, in its quest for *Juche* in pursuit of its impressive early industrialization, Pyongyang became heavily dependent on Soviet aid.³⁹ Once the Soviet Union fell, Pyongyang was not prepared to enter the world economy. Roh Tae-woo's policy of "Nordpolitik" further isolated the North from Beijing and Moscow. By the same token, Pyongyang, with its own behavior, further isolated itself from Washington and Tokyo.

According to Samuel Kim, the fall of communism in Eastern Europe, the dissolution of the Soviet Union, and poor management and decision making by the DPRK leadership had cumulative effects on the North Korean economy leading to its decline in the 1990's.⁴⁰ The events resulted in:

- The sudden demise of Soviet aid.
- The collapse of the socialist world market.
- The structural problems of the command economy with little material incentives.
- The over-allocation of resources to heavy industry and military spending.
- The inordinate misappropriation of human and natural resources dedicated to the deification of its leadership.

As a result, the North Korean economy contracted by a fourth from 1990-1995, with an average annual growth of negative 5.3 percent over that period.⁴¹

³⁸ Dae Hwan Kim and Tat Yan Kong, ed. *The Korean Peninsula in Transition* (New York: St. Martins Press, 1997), 183.

³⁹ Dae Hwan Kim and Tat Yan Kong, 120.

⁴⁰ Samuel S. Kim, "The Future of the Post-Kim Il Sung System in North Korea," in *The Two Koreas And The United States: Issues of Peace, Security, and Economic Cooperation*. ed. Wonmo Dong (New York: M. E. Sharpe, 2000), 38.

⁴¹ Samuel S Kim, "The Future of the Post-Kim Il Sung System in North Korea," 38.

By the end of the Cold War in 1991, the North Korean economy had reached crisis stage. As a result, the country faced the onset of a food crisis and potential famine. By 1995, the DPRK officially made diplomatic appeals for food. By 1998, foreign official and unofficial reports estimated that between 2 and 3 million people had died of starvation since 1991.⁴²

3. Current Conditions

In the North, all aspects of life have been state-governed, just like the means of production. Food is either rationed by the government or distributed in the rural areas according to each member's work contribution. The government rations cereals bi-weekly, work clothes and ordinary dress twice a year, and a pair of other woven goods every quarter. People can buy necessary goods either in state or cooperative stores or in the secondary market in limited quantities. All housing units are socialized "all-people ownerships" or "cooperative ownerships." Only the small party and government elite enjoys access to a larger variety of goods and services. The vast majority of the country lives in a similar condition of despair.⁴³

The decision to stick with a failing centrally planned economy when it has been abandoned everywhere else in the world is the source of the North's economic problems. Even after Kim Il-sung died in 1994, the regime never swayed from his course and even today echoes his same stringently socialist philosophy of self-reliance. This allows no reform and closes the possibility for constructive feedback inside as well as outside the government. In China and Vietnam, as part of their economic reform effort, there is no problem in admitting to the failures of previous policies. Still, like the days of Chairman Kim, the North still spends a large amount of its resources on pet projects and monumental structures and a tremendous amount on the military.⁴⁴

North Korea is a swollen garrison state, fielding the fifth largest army in the world. The ratio of troops to total population is by far the highest for any country in the post-Cold War era. Counting the 1.2 million men on active duty and the 5.9 million in

⁴² Eberstadt, *The End of North Korea*, 46.

⁴³ Dae Hwan Kim and Tat Yan Kong, 75-77.

⁴⁴ Dae Hwan Kim and Tat Yan Kong, 132-133.

reserve, 29 percent of the DPRK's population is in the military.⁴⁵ The direct defense expenditure in North Korea is estimated to be around 25 percent of its GDP. However, it is estimated that up to 50 percent of the DPRK's national income is spent, directly or indirectly, on military needs, thus reducing its capacity to meet basic human needs.⁴⁶ Regardless, economic difficulties have been witnessed affecting military readiness. Training exercise have been significantly reduced due to lack of fuel and spare parts as well as food shortages. It is even reported that the morale of the troops is severely being affected by the shortages.⁴⁷

Today, North Korea is one of the world's most centrally planned and isolated economies, facing desperate economic conditions. Industrial capital stock is nearly beyond repair as a result of under investment and spare parts shortages. The nation faces its seventh year of food shortages because of weather related problems, including major drought in 2000, and chronic shortages of fertilizer and fuel. Massive international food aid deliveries have allowed the regime to escape the major consequence of spreading economic failure, such as massive starvation, but the population remains vulnerable to prolonged malnutrition and deteriorating living conditions. Large scale military spending eats up resources needed for expanding investment and consumption goods. In 2000, after the historic inter-Korean summit, the regime placed emphasis on expanding foreign trade links, embracing modern technology, and attracting foreign investment. But in no way did it relinquish central control over key national assets or undergoing market-oriented reforms.⁴⁸

The North Korean economic model of self-sufficiency has failed. Because the North has neglected infrastructure and focused its economic spending on its military buildup, it has failed its ideal of self-sufficiency. When the Soviet Union fell and China withdrew its aid, the North Korean economy suffered tremendously. When floods devastated the country in the early 1990s, the DPRK lacked the technology and the

⁴⁵ Samuel S Kim, "The Future of the Post-Kim Il Sung System in North Korea," 37.

⁴⁶ Samuel S. Kim, *Korea's Globalization* (New York: Cambridge University Press, 2000), 107.

⁴⁷ Norman D. Levin, "The Two Koreas: Dealing with Adversity" (Santa Monica, CA: Rand Corporation, 1999), 5.

⁴⁸ Marcus Noland, "Between Collapse and Revival: A Reinterpretation of the North Korean Economy," paper presented at the conference on Economic Development in North Korea and Global Partnership, Cheju, South Korea, 15-16 March, 2001 (Washington, DC: Institute for International Economics)

economic resources to cope. As a result of the natural disasters and lack of fertilizer and external food sources, famine has overtaken the country, killing an estimated 1.2 million people.⁴⁹ Over the same period, South Korea saw unprecedented economic growth, aside from the downturn of the 1997 Asian economic crisis, by successfully implementing an export-oriented industrial strategy.

C. PROSPECTS

North Korea is facing the common problems of a centrally planned economy; lack of innovation, poor quality control, declining productivity, and above all, massive food shortages. These issues are catastrophic in proportion and have closely intertwined economics and politics. As the economic base beneath the North Korean state falters and the prospect of state failure draws closer, the lethal power in the hands of the regime and the leadership's incentives to exploit it continue to increase. Despite North Korea's severe economic difficulties, the country's ambitious military program continues to move ahead as evident from the North's supposed nuclear arms development and the August 1998 firing of a Taepo Dong-1 rocket over the main island of Japan.⁵⁰ It even seems possible that the North's "military burden," the ratio of the DPRK's defense expenditures to national output, may have actually risen over the course of the 1990's.

North Korea has made clear it cannot risk the political fallout of major economic changes. In response to growing economic crisis, the leadership restructured the government, not to seek reform, but to preserve the existing system. The DPRK regime is unwilling to unleash the unpredictable political forces economic change would generate as a result of greater exposure to the outside world.

⁴⁹ "Background Notes: North Korea." U.S. Department of State, Bureau of East Asia and the Pacific. October 2000: http://www.state.gov/www/background_notes.

⁵⁰ Eberstadt, *The End of North Korea*, 122-124.

III. THE ROAD TOWARD INTEGRATION AND UNIFICATION

Debated and predicted since the end of World War II, the prospect of Korean unification seems closer than ever, yet never has it been more distant. The Korean peninsula was the crossroads of the Cold War, entrenching the division and making inter-Korean dialogue nearly impossible. Both sides embarked on efforts of rapprochement and progress toward peaceful unification during that very tense period, but made little headway. The rapid succession of momentous changes in the international system from 1989 to 1991 – the crumbling of the Berlin Wall, German reunification, the end of the Cold War and the demise of the Soviet Union and of international communism – created the most glaring hope that divided Korea was heading inexorably toward reunification. However, the two still stand divided today. Nevertheless, recent efforts supporting mutual recognition and legitimation have brought the two Koreas closer to a peaceful coexistence as two separate states.

A. NORTH KOREAN EFFORTS

The reunification of Korea on the DPRK's own terms, has been an overriding policy objective for the North since the formal division in 1948.⁵¹ The existence of another Korean state poses the largest threat to the legitimacy of the North Korean regime. Thus, unification is considered essential to guaranteeing continued state existence. As history points out, this goal motivated the surprise attack on the South in June 1950. That strategic move was nothing more than the execution of the North's unification policy. The policy has since been interpreted as the termination of the ROK.⁵²

One of the earliest North Korean proposals for peaceful unification came in 1960. Amidst social and political unrest in South Korea, Kim Il-sung issued a proposal for the creation of a "confederation of North and South Korea." Kim's assumption was that the North must find a way to reduce South Korea's deep-seated mistrust of the communist

⁵¹ Eberstadt, *The End of North Korea*, 25.

⁵² Marcus Noland, "The Future Of North Korea," *Korean Journal of Defense Analysis* (May 2002), 26-28.

system in order for the two Koreas to at least coexist.⁵³ The plan would have let both Koreas maintain their respective political systems and autonomy while creating an environment where they could both cooperate economically and culturally. The proposal called for a commission to facilitate trade and economic cooperation among the different economic and trading sectors. The idea, though staunchly opposed by Seoul at the time, could be considered the prophetic foundation of the South Korean objectives today. The proposal is strikingly similar to what is envisioned by Kim Dae-jung's "Sunshine policy."⁵⁴

The North Korean unification policy has, however, become a race against time. Growing economic problems, the fall of communism in Russia and Europe, and the thaw in ties between China and South Korea put the North's policy into serious jeopardy with the absence of any outside support with which to develop legitimacy. Thus, the North's policy of communizing the Korean peninsula had reached a dead end. South Korea's entry to the United Nations (UN) is arguably the severe blow for the North Korean regime, causing a reversal in the North's policy that Korea should have a single united voice within the international community. As a result, the DPRK agreed to join the UN at the same time the ROK was admitted entry.⁵⁵

The DPRK's policy objectives toward the ROK are, to all intents and purposes, synonymous with its policy objectives toward the rest of the world. The objectives are: to maximize North Korean domestic security; to obtain international recognition at the expense of the ROK, if not as the only lawful Korean government on the peninsula, then as the coequal half of the Korean nation; to reunify Korea by forcing the withdrawal of U.S. troops from the South and by eliminating the rival regime in Seoul; and, pending unification, to persuade the ROK government to accept the practicality of peaceful coexistence within a framework of dialogue and mutual cooperation.⁵⁶

⁵³ Young C. Kim, ed. *Major Powers and Korea* (Silver Spring, MD: Research Institute on Korean Affairs, 1973), 89.

⁵⁴ Helen-Louise Hunter and Stephen J. Solarz. *Kim Il-song's North Korea* (New York: Praeger Pub Text, 1999), 101.

⁵⁵ Hunter and Solarz, 11.

⁵⁶ Young C. Kim, 86.

B. SOUTH KOREAN OVERTURES

The 1970s were a time of great progress and change, as well as regression and entrenchment. The general direction of the decade was that Kim Il-sung and the North Koreans clung strictly to his purpose of unifying Korea on his terms. However, he shifted his strategy between force and diplomacy when it most benefited his cause. Park Chung-hee, by contrast, de-emphasized unification and relentlessly pushed ahead with his economic plans designed to increase the South's prosperity. However, he often met resistance because, instead of relaxing his militaristic style and authoritarian discipline over society, he increased it.⁵⁷

The first steps toward engaging the North were taken by President Park in August 1970 when he suggested that the ROK was willing to co-exist peacefully with the DPRK. He urged both sides to mutually replace hostile military confrontation with socioeconomic competition. His efforts led to the historic July 4, 1972 joint communiqué between the North and South, which emphasized pursuing unification independently and peacefully by transcending any differences with national unity.⁵⁸ Listed as follows, the principles were simply stated and amounted more to an agreement of non-aggression than of cooperation.

“Unification should be achieved by Koreans without outside interference; that it should be achieved by peaceful means, not by the use of force; that neither side defame the other or engage in armed provocations, and that both would cooperate positively in the Red cross talks; that a direct telephone ‘hot line’ would be installed between Seoul and Pyongyang; and that a North-South coordinating committee would be established to solve various problems between the two sides and settle the unification problem on the basis of the principles agreed on.”⁵⁹

Little progress toward unification was made by dialogue was established, but with little consequence of commitment to further coordination.

In 1982 President Chun Doo-hwan issued a statement announcing a new peaceful unification formula that decried the awkward and un-natural relations between the North and South. He stressed the need for normal contacts between both states to promote

⁵⁷ Oliver, 297.

⁵⁸ Yong-Sup Han and Norman D. Levin, *The South Korean Debate Over Policies Toward North Korea: Issues and Implications*, (Santa Monica, CA: Rand, December 2001), 4.

⁵⁹ Ralph N. Clough, *East Asia and U.S. Security*, 167.

“national” well-being. Chun even suggested that by promoting a broad range of economic exchanges and cooperation including, but not limited to, trade, transportation, and communications, relations should be normalized.⁶⁰

In July 1988, President Roh Tae-woo further clarified the idea of engagement with North Korea, defining the goals that engagement policy should embrace. Roh believed that the reason the Korean peninsula continued to be divided was not the fault of the policies of either side, but rather the notion that each side regarded the other as an adversary. He stressed the need for each side to view North-South relations as potential partners in pursuit of the common goal of prosperity. Roh made the first concrete steps to implement this proposal by creating legal and administrative mechanisms in the South to regulate economic interactions. He then called for a balanced development of both Korean economies, suggesting that the prosperous South aid and assist the deteriorating North.⁶¹

President Kim Young-sam further elaborated an engagement policy, declaring that the South had no desire to “absorb” the North, as the German unification scenario would indicate. Kim then called for an inter-Korean summit, stressing the need to create a single national community. Kim Il-sung formally accepted the invitation for a summit, but died shortly after. Kim, however, continued to stress peaceful unity and labeled the North’s food shortages and economic problems as problems for the South as well. Kim subsequently became the first President to give direct aid to the North in any form.⁶²

Kim Young-sam’s policy on reunification specified a three-stage process: reconciliation and cooperation; a Korean commonwealth; and a single nation-state.⁶³ Kim’s administration viewed the example of German unification as a very possible, and even likely, Korean scenario and feared the enormous economic costs. As a result, he felt that greater economic aid from the South would lure the North toward a more acceptable path and lead to greater opportunities of investment and joint ventures, which in the long

⁶⁰ Han and Levin, 5.

⁶¹ Han and Levin, 6-8.

⁶² Nicholas Eberstadt, "Economic Recovery in the DPRK: Status and Prospect," *International Journal of Korean Studies*, Vol. IV, No. 1, (Fall/Winter 2000), 78.

⁶³ Dae Hwan Kim and Tat Yan Kong, 170.

term would lead to a penetration of North Korean society.⁶⁴ Nevertheless, during Kim Young-sam's administration, the North placed numerous impediments in the way of inter-Korean rapprochement through trade.

The early 1990s saw a dramatic increase in inter-Korean contacts and negotiations, culminating in the agreement on "Reconciliation and Non-Aggression." After a series of high-level exchanges agreement was reached to further promote cooperation and exchanges while pledging not to threaten use of force against one another. This agreement, along with the denuclearization declaration that both cooperated in creating, solidified the South's commitment to an engagement policy toward the North.⁶⁵ The agreement included avenues for creating joint economic ventures and sharing state visits by cabinet level officials. However, by the end of 1992, the DPRK had seemed to revert back to its familiar policies and practices. Economic conditions in the North had become grave, and experimentation with economic reforms was strongly resisted. By 1993 North Korea's unification policy was irrelevant, given the condition at hand. The pressing problem was now regime survival.⁶⁶

In 1994, the United States and the DPRK signed the Agreed Framework, by which the DPRK agreed to freeze its nuclear development while the Korea Peninsula Energy Development Organization (KEDO) – a consortium of countries led by South Korea, the United States and Japan – agreed to provide two light-water reactors (LWR) for two power plants in the North.⁶⁷ Initially, when the LWR project was launched, discord broke out between the South and North Korean workers deployed for the project, mostly due to differences in culture and perception. Such tensions, however, gradually ebbed away. Preliminary work for the LWR construction site began in August 1997, and the full-fledged work started in February 2000, when the project's main contract went into effect. In early spring 2001, site preparation work at Kumho was completed, but construction has since made slow but significant progress.⁶⁸

⁶⁴ Dae Hwan Kim and Tat Yan Kong , 173.

⁶⁵ Han and Levin, 10-11.

⁶⁶ Nicholas Eberstadt, "Economic Recovery in the DPRK: Status and Prospect," 38.

⁶⁷ *Agreed Framework Between The United States of America and The Democratic People's Republic of Korea*, signed in Geneva (October 21, 1994)

⁶⁸ Son Key-young, "Seoul Braces For Revision Of Agreed Framework," *Korea Times* (May 22, 2001)

C. SUNSHINE POLICY

Shortly after his inauguration in February 1998, ROK President Kim Dae-jung made clear that finding a way for the North and South to live together peacefully, rather than achieving unification, would be his top priority. He thus unequivocally ruled out absorbing North Korea as a goal of South Korean policy, seeking peaceful co-existence, reconciliation, and cooperation between Seoul and Pyongyang instead.⁶⁹ By adopting this approach toward relations with the North, President Kim ordered any reference of the word “unification” removed from all official government documents, publications, or speeches. He instead substituted terms like “policies toward the north” and “constructive engagement policies.” Kim has not jettisoned the goal of eventual unification by adopting the Sunshine Policy, but he sees it as a long-term goal. Driven by the expected costs of unification and a fear of the absorption scenario, Kim instead chose the short-term goal of peaceful coexistence and cooperation that would eventually set the stage for unification.⁷⁰ The administration formally predicated its policy on three basic principles.

- No toleration of North Korean armed provocations.
- No South Korean efforts to undermine or absorb the North.
- Active ROK attempts to promote reconciliation and cooperation between the two Koreas.

One of the core components of this policy is the separation of politics and economics. The South’s private sector was thus allowed greater leeway in making its own decisions concerning trade and investment with the North. It also meant that the administration would ease restrictions that hindered inter-Korean business, while limiting the government’s role primarily to matters of humanitarian and other official assistance. These actions underlined President Kim’s belief that the North would be more receptive to economic than political inducements.⁷¹

Kim’s stated objective is to create a single joint economic sphere that would propel development over time of a broader socio-cultural community. To expand that

⁶⁹ Levin, “The Two Koreas: Dealing with Adversity,” 10.

⁷⁰ Yang Young-Shik, “Kim Dae-jung Administration’s North Korea Policy,” *Korea Focus* (November-December 1998), 48.

⁷¹ Han and Levin, 13.

goal through economic cooperation, the Kim Administration has encouraged businessmen to visit the North, lifted the ceiling on investment allowed in the North, and simplified legal procedures. There were also efforts to reach agreement with the North to prevent double taxation and guarantee essential investments. However, as Norman Levin points out, “expanded economic cooperation is intended to benefit both Koreas. But the [Kim] administration has been explicit that it will focus first on areas most important to the North, partly because of Seoul’s superior economic position and partly because of Pyongyang’s paranoia about South Korean ‘penetration.’”⁷²

Over the first three years of the Kim Dae-jung Administration (March 1998-April 2001), the South provided the North with \$230 million in combined government and private channel assistance. This figure is a decrease compared to the amount expended in the three previous years (June 1995-February 1998), which totaled \$284 million.⁷³ Of the \$4.3 billion planned for investment in the North in 2002, 96 percent, or \$4.1 billion, was planned for the light water reactor project. That leaves a remaining \$171 million for direct investment into other projects.⁷⁴

Total aid covering the whole period from 1998 (the first year of Kim Dae-jung’s government) through 2001, stood at \$188 million (235 billion won), which amounted to less than two dollars per South Korean a year. In terms of the ROK GDP, the year of 2000, when the largest amount of aid was provided (\$110 million), is a case in point. The aid amount of that year was equivalent to 0.024 percent of the nation’s GDP of \$455.2 billion. While it is clear that the aid amount was rather small, it is equally important to note that the aid served an even greater cause – extending humanitarian assistance to brethren in the North. This aid will no doubt help to reduce the threat of war on the Korean peninsula. In the long run, the assistance may prove to be a wise investment for a more promising economic future for both Korea’s, while in the short run it may help revive the North Korean economy.⁷⁵

⁷² Han and Levin, 17.

⁷³ The Ministry of Unification, “Toward an era of Peace and Cooperation.” (The Korean information Service, June 2001), 50.

⁷⁴ Kim Young-Yoon, “Investment For Balanced Growth Between North and South Korea.” *Korea Focus*, Vol. 9, No. 1 (January-February 2001), 29.

⁷⁵ The Ministry of Unification, 24-26.

Critics of the Kim Dae-jung Administration are numerous. Norman Levin and Yong-Sup Han do, however, summarize the most common skepticism of the “Sunshine Policy.”

“Many South Koreans reject the Administration’s assumption that major internal changes can be produced in the North by providing ‘assurances’ of the regime’s survival. They also do not believe that South Korea can induce the North to end its hostility and accept peaceful coexistence simply by renouncing ‘absorption,’ conveying ‘sincerity’ in desiring reconciliation, and encouraging the U.S. and others to normalize relations with Pyongyang.”⁷⁶

Nevertheless, from 1998 to the end of 2001, a total of 24,747 South Koreans traveled to North Korea. The number represents more than a ten-fold increase over the 1989-1997 period, when only 2,405 visits were recorded.⁷⁷

1. 2000 Inter-Korean Summit

The inter-Korean summit meeting in June 2000 marked a new beginning. For the first time since Korea was divided 54 years ago, the top leaders of South and North Korea met to discuss peace and reunification. President Kim Dae-jung proposed the inter-Korean summit meeting in his inaugural speech in 1998 and repeated the proposal at every opportunity thereafter. During a visit to Berlin in March 2000, President Kim reiterated the need for government-level dialogue in order to promote economic cooperation between Seoul and Pyongyang. Shortly thereafter, Kim Jong-il accepted the invitation and agreed to host President Kim in Pyongyang.

Through conferences over three days and two nights, the two leaders reached the fundamental understanding that only dialogue and cooperation would promote the prosperity and peaceful reunification of their homeland. On the basis of this understanding, they created a South-North joint declaration, which states:

“The South and the North have agreed to resolve the question of reunification on their own initiative and through the joint efforts of the Korean people, who are the masters of the country...Acknowledging that there are common elements in the South's proposal for a confederation and the North's proposal for a federation of a lower stage as the formulae for

⁷⁶ Han and Levin, viii.

⁷⁷ Selig Harrison, *Korean Endgame: A Strategy for Reunification and U.S. Disengagement* (Princeton: Princeton University Press, 2002), 4-6.

achieving reunification, the South and the North agreed to promote reunification in that direction...The South and the North have agreed to consolidate mutual trust by promoting balanced development of the national economy through economic cooperation and by stimulating cooperation and exchanges in civic, cultural, sports, public health, environmental and all other fields.”⁷⁸

The declaration confirmed the principle that the Korean people should resolve Korean problems themselves. It said there exists common elements in the unification formula of both South and North Korea. This clause effectively removes unnecessary controversies over whose formula is preferable.

The ministerial talks that followed the summit have produced agreements to carry out the South-North joint declaration. The two sides agreed to reconnect a railway between the North and South, open an overland route to Mt. Geumgang, the scenic mountain in North Korea, and develop an industrial complex at Gaeseong near the border. Subsequently, agreements were reached regarding several joint economic and development ventures.⁷⁹

- Construction work to reconnect the Seoul-Sinuiju Railway and a parallel highway, and opening them at an early date;
- Construction of the Gaeseong Industrial Complex;
- Study on linking gas pipelines to and from South Korea through Russia and China;
- Working-level consultations to allow the passage of merchant shipping through the two Koreas' respective exclusive waters;
- A field survey for flood prevention measures along the Imjin River basin; and
- Consultations on possible joint fishing operations in the East Sea.

In the joint declaration the two Koreas agreed to promote balanced development of the national economy through economic cooperation. There were six rounds of talks on economic cooperation, three each in 2000 and 2001, to implement this particular point of accord. There were two rounds of working-level contacts to work out a legal framework for expanding inter-Korean economic exchanges on a permanent basis, and a

⁷⁸ Harrison, 47-49.

⁷⁹ Harrison, 101-103.

meeting of the Committee for the Promotion of Inter-Korean Economic Cooperation was held. Meetings were also held on electricity supply from the South, on prevention of flood damage along the Imjin River, and on the Mt. Geumgang tourism project. In order to promote stable economic exchanges, South and North Korea produced four agreements on investment protection, settlement of commercial disputes, prevention of double taxation and clearance of accounts.⁸⁰

a. *Reconnection Of Seoul-Sinuiju Railway And Road*

The two sides agreed to reconnect the Seoul-Sinuiju Railway and road during the first two rounds of ministerial talks. In addition, the two defense ministers agreed in principle on entry and security procedures in the DMZ for personnel and materials involved in the project. The South broke ground for the work in a ceremony on September 18, 2000 and completed repairing the railway on the southern segment at the end of December 2001. The formal signing of a military guarantee agreement is still pending, however.⁸¹

Since September 30, 2001, railway service started between Munsan and the Imjin River station near the border five times a day on weekdays and nine times on weekends and holidays. The state-run Korea National Railroad is using the re-linked portion for tourism and national security education. It also plans to run special trains for the old refugees from the North to come near the border to pay respect to their relatives in North Korea during traditional holidays.⁸²

b. *Joint Imjin River Flood Prevention Project*

The Imjin River project will enable the two sides to pool their efforts to prevent flood damage along the North-South border and make a peaceful use of the river and the adjoining DMZ area in the long run, bringing benefits to both sides. At the second ministerial meeting, the two sides agreed to push for a joint Imjin River flood

⁸⁰ Byung Chul Koh, ed. *Korea: Dynamics of Diplomacy and Unification*. Monograph Series, Number 12 (Claremont McKenna College: Keck Center for International and Strategic Studies, 2001), 174.

⁸¹ "Background Notes: Korea." U.S. Department of State, Bureau of East Asian and Pacific Affairs (June 2001), http://www.state.gov/www/background_notes.

⁸² Byung Chul Koh, *Korea: Dynamics of Diplomacy and Unification*, 86.

control project at an early date. And they were able to considerably narrow the differences as to how they will form a survey team and conduct the study during the first session of the Committee for the Promotion of Inter-Korean Economic Cooperation and at a working-level consultative meeting.⁸³

During the fifth ministerial talks, they also agreed to begin a field survey along the river as soon as necessary steps are worked out between the military authorities. Although implementation of these agreed points has been delayed, the South is fully ready to comply with the joint field survey and others steps. It also intends to promote cooperation in water resources development in other rivers flowing across the border.⁸⁴

c. Development Of Gaeseong Industrial Complex

An agreement to develop the Gaeseong Industrial Complex was concluded between Hyundai Corporation and North Korea's Asia-Pacific Peace Committee in August 2000. This led Hyundai and the Korea Land Corporation to conduct a feasibility study in the Gaeseong area for the industrial complex.⁸⁵

Once the projected industrial complex is built, South Korea's technology and capital will be combined with North Korea's manpower. Such a development would help small businesses in the South regain international competitiveness while distributing wages to North Korean workers. South Korea is asking the North to enact laws related to wages, employment, land leasing, taxes and remittances at an early date for Southern companies' free production activities in North Korea.

d. Areas Of Concern

The fourth item of the joint declaration called for balanced economic development through cooperation. This would entail two major efforts. First, the South would have to invest capital, resources, and infrastructure in the North over a long period to bring the DPRK to the level of the ROK. Public enthusiasm over time, as reflected in public opinion polls conducted by the *Korea Herald*, shows declining support for this

⁸³ "Background Notes: Korea"

⁸⁴ CIA. *The World Factbook – Korea, North*. <http://www.cia.gov/publications/factbook>.

⁸⁵ Byung Chul Koh, *Korea: Dynamics of Diplomacy and Unification*, 34.

idea as the Korean economy slowly recovers from the Asian economic crisis. Secondly, the declaration called for greater economic integration. Again, public opinion shows declining support given the enormous gap between the two economies and the ROK's own economic difficulties.⁸⁶

The majority of the project agreements that give South Korean cash payments to the North provide neither restrictions nor control over their use by the North. Such payments can thus be allocated however the North wants, including the acquisition of tanks, missiles, artillery and other weaponry.⁸⁷ The Mt. Kumgang project involves activities far removed from North Korean population centers, thus significantly limiting the opportunity for discovery. This is a critical element, however, for encouraging long-term change in the North. Nevertheless, the project isolates the South's investors, workers, and administrators from their Northern counterparts.⁸⁸

⁸⁶ Polling data summarized and quoted in, Han and Levin, 42.

⁸⁷ Kim Sun-hyuk, "The Politics of Dual Transition in South Korea: Economic Restructuring and Democratic Deepening" in *Korea in the 21st Century*, ed. Joo Seung-Ho and Kwak Tae-Hwan (Huntington, NY: Nova Science Publishers Inc., 2001), 18.

⁸⁸ Kim Sun-hyuk, 29.

IV. ECONOMIC INTEGRATION

Unification will require tremendous investment in the North. The cost estimates are staggering – as \$1 trillion, twice the amount of South Korea's current GDP.⁸⁹ Nevertheless, South Korea's economic superiority indicates that it will lead the unification effort. However, even with outside assistance, South Koreans would have to bear severe taxes and harsh economic sacrifices to meet the costs. Therefore, the South Korean government must become more involved in the private activities of the South's business firms, which pursue commercial interest only, to promote Northern economic exchanges and cooperation with consistency.⁹⁰ Also, North Korea must open its doors to South Korean capital and technology, because this is the first step to prepare the two sides to recover homogeneity and expand inter-Korean economic cooperation.

A. ENGAGEMENT JUSTIFICATION

The most advantageous scenario for Korean unification calls for economic unification prior to political unification.⁹¹ This approach measures the resources necessary to raise North Korea to some percentage of South Korean income in order to ease the harsh economic consequences of unification. The odds are against South economically stronger in the near term upon unification. The negative data are intuitive given the dire conditions in North Korea, thus supporting the idea of gradual unification.⁹²

Most cost estimates of unification assume that the South would be required to raise per capita income in the North to parity with that of the South.⁹³ But even in developed countries, it is not unusual to have levels of economic development that differ from region to region. However, the extent of the current disparity between North and South would have to be ameliorated to ease the pain of unification. It is possible that

⁸⁹ Marcus Noland, *Avoiding The Apocalypse*, 23.

⁹⁰ Marcus Noland, *Avoiding The Apocalypse*, 17.

⁹¹ Marcus Noland, *Economic Integration of Korean Peninsula*, Special Report 10. (Washington, DC: Institute for International Economics, 1998), 3-13.

⁹² Marcus Noland, *Economic Integration of Korean Peninsula*, 35.

⁹³ Marcus Noland, Sherman Robinson, and Tao Wang, "Rigorous Speculation: The Collapse and Revival of the North Korean Economy," *World Development*, 28:10 (2000), 87.

economic growth in the North, spurred by foreign and ROK investment, could offset some of the expense of unification.

If that investment is eventually accomplished, it is far better to attempt to begin that effort now, when unification is still well into the future, than to be faced with rebuilding a North Korean economy that has experienced several more years of contraction. Some may doubt whether trade and investment in North Korea should be undertaken at a time when the regime's behavior is characterized more by intransigence than by cooperation.⁹⁴ However, it is those engagement practices that are credited with moving communist China toward increased engagement with the West and adopting market reforms. The two nations are different in many respects, but the true effectiveness of engagement policies toward North Korea cannot be judged until they are undertaken in full measure, without regard to quid pro quo responses.⁹⁵

The fundamental goal of inter-Korean economic exchanges is to upgrade the level of national welfare after unification by establishing a foundation for a national community in the present. Therefore, inter-Korean economic exchanges should be implemented by consistently taking into account long-run considerations for restoring peaceful coexistence. Each of these steps will eventually aid in creating market-based reforms in the North, which will greatly aid in transitioning the North's economy during the unification process.

The greatest challenge will be in encouraging businesses to invest in North Korea. North Korea's starving, impoverished and significantly smaller populace forms a much less promising consumer base than China. The ROK would have to provide incentives and loan credits to jump start investment in the North. However, a lifting of trade sanctions could ease the barriers to humanitarian assistance efforts, paving the way for more profit-driven endeavors in the future.⁹⁶ Even ROK President Kim Dae-jung, in keeping with his "Sunshine policy," has advanced the need to separate politics and economics with respect to the North. Kim's goal is to decrease North Korea's isolation

⁹⁴ "Seoul On Thin Ice," Editorial, *Wall Street Journal* (March 6, 2001)

⁹⁵ , Daniel H Rosen. "China and the World Trade Organization: An Economic Balance Sheet," *Institute for International Economics*, Number 99-6 (June 1999)

⁹⁶ Marcus Noland, *Economic Integration of Korean Peninsula*, 42-44.

and relieve its grinding poverty and famine. Although Kim seeks a separation of political and economic issues, it is clear that he feels the best chance for making political inroads is to pave the way economically.⁹⁷

Nicholas Eberstadt labels four “independent, but interrelated” arguments supporting “rapprochement through trade.”⁹⁸

- First, “the North Korean system is objectively in need, perhaps in desperate need, of precisely those quantities that intensified inter-Korean economic coordination could provide.”
- Second, “North Korea’s leadership is well aware of the country’s deep economic difficulties and of the urgency with which trade opportunities and other international economic contacts must now be pursued.”
- Third, “an economic opening in North Korea would be in South Korea’s own financial interest, rather than simply an exercise in checkbook diplomacy.”
- Fourth, “South Korea has a record of demonstrated success in bringing formerly hostile communist states to the point of rapprochement and beyond, through economic diplomacy.”

Taken together, all four points comprise a convincing argument as to why it is in the interest of both South and North Korea to expand commercial ties. For the South, the North is an untapped resource to increase production and profits. The opportunity for investment seems to be developing, because in the past, North Korean leaders have been blind to the inefficiencies of their economy. Today, the regime seems to be completely aware of its inefficiencies, which bodes well for the prospect of progress. South Korea has the experience of opening relations with China, the Soviet Union, and many East European nations when it was neither popular nor unproblematic to do so. So the challenge of opening North Korea is one for which it is well suited.⁹⁹

Nevertheless, the issues surrounding North Korea make it a unique situation unto itself. The greatest fear of the DPRK regime is that outside forces that may destabilize the socialist system or disrupt the regime’s legitimacy. A long-held belief in the North is that

⁹⁷ “The Korean Economy and Economic Policy”

⁹⁸ Eberstadt, *The End of North Korea*, 70-74.

⁹⁹ Eberstadt, “Economic Recovery in the DPRK: Status and Prospect,” 121.

capitalist and imperialist forces intend to do just that. With that in mind, the regime in power now would be the same one faced with adopting the much-needed economic reforms and heading the majority of the joint venture projects recommended. These actions in the North's view have enormous potential to create social chaos. In addition, the same policy makers who led the country on a downward spiral also have no economic merit to assess alternative proposals that would aid development. It can be deduced that DPRK authorities, for reasons of self interest may continue to not support greater economic integration with South Korea and the rest of the capitalist world, regardless of the growing need for such.¹⁰⁰

President Kim Dae-jung's "Sunshine policy," compounded by the fact that North Korean economy is near collapse and its people are starving, presumes that deepening economic coordination between the North and the South will lead to greater rapprochement. By expanding trade, development projects, and joint ventures, tensions can be lessened and mutual financial interest will outweigh ideological confrontation. This theory would create a two-fold success. First, greater economic coordination now will ease the pain of economic integration when the Korean peninsula is unified. Second, by increasing commercial ties, the North Korea regime will be indirectly exposed to liberalizing forces, thus creating an environment more conducive to change.¹⁰¹

1. Current Efforts and Successes

The Kim Dae-jung government has established its priority on providing fertilizer to help improve North Korea's agricultural output as well as emergency relief food to help alleviate the North's chronic food shortage problems. Since 1998, private-sector aid to the North has totaled \$150 million. The government has also paid special attention to improving the public health and medical situation, with particular emphasis on the underprivileged class of North Korean society. South Korean aid to North Korea since

¹⁰⁰ Thomas H. Henriksen and Jongryn Mo, *North Korea After Kim Il Sung: Continuity Or Change?* (Stanford, CA: Hoover Institution Press, 1997), 75-78.

¹⁰¹ Ralph C Hassig, (et. al.). *North Korea through the Looking Glass* (Washington, DC: The Brookings Institute, 2000), 69-71.

the year of 1998 totaled \$183.3 million, amounting to about 17 percent of the total aid provided by the international community.¹⁰²

While maintaining the basic policy of providing direct support, the government also participated in humanitarian relief programs sponsored by UN organizations. For example, it supplied 100,000 tons of corn in 2001 under the World Food Program and provided malaria vaccines to the World Health Organizations campaign to prevent the spread of malaria in North Korea.¹⁰³

Private sector assistance to the North has complemented the government's program. The private-sector aid has developed from occasional relief assistance to continuous and specialized support for agricultural development and medical services. Moreover, items included in these programs are diversified to include agricultural products and equipment in addition to various medicine and other pharmaceutical supplies. Private sector programs have shown that technical assistance and long-term recovery projects to improve agricultural output are possible in addition to in-kind aid.¹⁰⁴

- Agricultural area: Seeds improvement, livestock farming, growing vegetables, supply of farming materials, etc.
- Medical/public health area: Shipment of tuberculosis vaccine, modernization of hospital facilities, pharmaceutical supplies, etc.
- Environmental area: Reforestation, participation in the program to prevent damage to pine forests caused by blight and harmful insects, etc.

Inter-Korean trade, which totaled \$18.7 million in 1989, soared to \$100 million in 1991, \$200 million in 1995 and \$300 million in 1997. Trade volume fell to the \$200 million range in 1998 due to an economic downturn (caused by a foreign exchange crisis) before recovering the \$300 million range a year later. The year 2000 saw inter-Korean trade at its highest level of \$425 million, and approximately \$400 million recorded last year. Also up sharply were the number of participating firms and items traded. A total of 30 companies registered in 1989 ballooned to 652 in 2000 with the number of items swelling from 26 in 1989 to 646 in 2000. If the Seoul-Sinuiju Railway begins operation,

¹⁰² Ministry of Unification, 15-17.

¹⁰³ Ministry of Unification, 28.

¹⁰⁴ Eberstadt, "Economic Recovery in the DPRK: Status and Prospect," 53-54.

inter-Korean trade, helped by a reduced transportation cost and a direct route, will gain added impetus, enhancing a competitive edge in terms of production and sales of goods.¹⁰⁵

2. Other Needs

It is essential for South and North Korea to have institutional devices in place to buttress inter-Korean economic cooperation such as investment protection and prevention of double taxation. This will permit entrepreneurs from the South to invest safely in the North, and both sides will be able to expand economic exchanges and cooperation on a stable basis. South Korea will need to work diligently to put into effect the four economic agreements regarding investment protection, prevention of double taxation, clearance of accounts and settlement of commercial disputes, and their follow-up measures. The South will also need to continue to develop other institutional devices, including rules on traffic and communications, certification of origin and industrial standards.

To achieve economic balance, the economic needs of the DPRK should also be considered in the political socio-cultural context. North Korea's social and economic system is highly inefficient and failing, as evidenced by negative fiscal growth, starvation, and sub-standard living conditions. Therefore, the North Korean regime needs to recognize the efficiency of the market system and the need to change its economic system to prepare for unification.¹⁰⁶

Samuel Kim lists changes in policies most essential for the North to achieve successful implementation of economic reform and economic integration with the South.

- “Thorough restructuring of the ownership system and the system of economic decision-making in Pyongyang, major agricultural reform coupled with the family owning system (decollectivization).
- Gradual expansion and extension of a free trade and economic zone from the Rajin-Sonbong area to other eastern and western coastal cities, even some

¹⁰⁵ IMF, *Country Information – Korea, Republic of*.

¹⁰⁶ Eberstadt, "Economic Recovery in the DPRK: Status and Prospect."

political reform measures keyed to the functional requirements of a market-oriented but still state led economy.

- Extensive opening to the global economic system with Pyongyang joining (are allowed to join) all the keystone international economic institution (e.g., APEC, Asian Development Bank, IMF, the World Bank, and WTO).
- Full normalization of relations with Tokyo with a compensation package of about \$12 billion in several categories (e.g., grants-in-aid, soft loans, and credits).
- Return to north-South dialogue and détente, if not a peace treaty, accompanied by considerable aid and great expansion of inter-Korean economic cooperation.
- Select and gradual demobilization of the Korean People's Army (KPA) to generate more labor force needed to fuel North Korea's modernization of agriculture, light industry, and science and technology.
- Sending students to, and inviting foreign experts from, Japan, the United States, and Europe for advance training, as post-Mao reformers have done since 1979.”¹⁰⁷

These policy steps do not require simultaneous execution and could be implemented separately and gradually. Obstacles stand in the way of each liberalizing recommendation, but they are neither insurmountable nor impossible to overcome.

B. OBSTACLES IN THE WAY OF INTEGRATION

One of the major issues standing in the way of economic integration is the extreme secrecy under which the North Korean regime operates. Accurate statistics are nearly impossible to collect, and the numbers that are released have very little credibility. State budgets are periodically released by Pyongyang, but often years after the fact. All other economic statistics are heavily guarded by the DPRK, out of a fear of exposing weaknesses. What data that can be gathered are highly analyzed, and estimates of North Korean economic activities are made, admittedly with a considerable amount of

¹⁰⁷ Samuel S. Kim, “The Future of the Post-Kim Il Sung System in North Korea,” 43-44.

speculation.¹⁰⁸ North Korea, instead of looking outward for ways to promote economic development, has been one of the most inward looking of nations. It has traded principally with the Soviet bloc and China, exporting mainly primary products. Such trade, has minimized the need for personal contacts between North Koreans and outsiders. It is a trading process well-suited to protecting the people of North Korea from undesired outside influences, but ill-suited to making the people and products of North Korea widely known throughout the world.¹⁰⁹ As a result, Pyongyang has fared poorly in attracting foreign investment in the Rajin-Sonbong free-trade zone, largely because of political restraints. In September 1998, the U.N. attempted to sponsor an investment fair in order to boost interest, but the DPRK excluded the participation of 60 South Korean firms at the last minute.¹¹⁰

In addition, the North Korean regime has resisted economic reform. Masao Okonogi points out:

“In essence, North Korea is facing the same dilemma that the Soviet Union and China faced. Clinging to the old political system and placing restrictions on people, goods, money, and information makes economic reconstruction impossible. Freedom in these areas, however, will bring to the surface the contradictions of the old system and produce political instability. Contact with the outside world that comes with economic opening and improvements in people’s livelihood will, in the end, necessitate a reform of the economic system (through the introduction of a market economy), and reform of the economic system will in turn lead to a reform in ideology and the political system.”¹¹¹

Nevertheless, faced with a food shortage of nearly 2 million tons in 2002 and a still moribund economy, North Korea’s desperation is growing. At the same time, the very success of its "feed me or I’ll kill you" extortion tactics over the past several years is constraining Pyongyang’s behavior even as it keeps North Korea on life support. The fact that the massive amounts of food, fertilizer and other international aid that have poured into North Korea from the United States, South Korea and the international community

¹⁰⁸ Marcus Noland, “The Economic Situation in North Korea,” in *The Two Koreas And The United States: Issues of Peace, Security, and Economic Cooperation*, ed. Wonmo Dong (New York: M. E. Sharpe, 2000), 22.

¹⁰⁹ Clough, *Embattled Korea*, 305-306.

¹¹⁰ Levin, “The Two Koreas: Dealing with Adversity,” 4.

¹¹¹ Masao Okonogi, “The North Korean Crisis and Japan’s Choice,” in *The Two Koreas And The United States: Issues of Peace, Security, and Economic Cooperation*, ed. Wonmo Dong (New York: M. E. Sharpe, 2000), 121.

since 1995 have given Kim Jong-il something to lose. This suggests new boundaries for North Korean behavior and increased leverage for United States-South Korean-Japanese trilateral diplomacy.¹¹²

C. POST-INTEGRATION AND UNIFICATION EFFECTS

A unified Korea will need to consider a strategic approach to maximize economic effectiveness and efficiency within an open and competitive free market framework. In the short term, the unified government will need to establish a balanced income distribution policy between the South and North Korean people.¹¹³ In the long term, an overall economic development plan will need to be developed with a focus on building the North while not sacrificing the South. This plan should also consider economic development within the region, as well as the global economic community. In order to achieve success, a large emphasis will need to be placed on the role of internal and regional corporations within a unified Korean economic market.¹¹⁴

After Korean unification, the total population of the Korean peninsula will be around 70 million people. This population level will be an attractive consumer group for domestic and international market incentives. Even though North Koreans are not familiar with market concepts, they will be able to gain knowledge and experience through a scaled and concerted transition process from their former system to the new system. South Koreans are immersed in the market system, but they will need patient and incremental reforms to aid the North Korean population.¹¹⁵

1. The Effects Of Unification On Japan

The ROK does not possess the capability to finance unification alone. Even a ROK foreign ministry estimate placed the cost of unification at \$1 trillion in 1999 with expected substantial growth every year the North-South economic gap widens. In order to alleviate this huge financial burden, the ROK will need considerable inflows of foreign

¹¹², Robert A. Manning, "Tactical Genius, Strategic Fool." *Washington Times* (May 15, 2001): 19.

¹¹³ Charles Wolf, "Forecasting Korea's Economy and the Costs of Reunification," (Santa Monica, CA: Rand Corporation, 1999), 6.

¹¹⁴ Wolf, 8.

¹¹⁵ Noland, Robinson, and Liu, 25.

aid and investment, before and after unification. While the United States, Europe, and the United Nations will pledge support, those efforts will not be substantial enough. The country that will have the greatest economic impact on unification is Japan.¹¹⁶ The greatest incentives for Japan are the cheap, literate and proximate Korean workforce. Korea will also possess a huge market for commercial exports and investment. Historical resentment aside, Japan and Korea have cooperated economically since normalization in 1965. During the economic industrialization of Korea in the 1960s and 1970s, Japan was the key source for foreign-capital. Unification will present a similar scenario to the Japanese.¹¹⁷

2. The Effects Of Unification On China

Following unification, China's greatest concern for Korea will be security, with Japan and China competing for the greatest sphere of influence over a unified Korean peninsula. Economically, China sees a unified Korea as a primary competitor for exports of manufactured goods. Korea, on the other hand, sees China as a long-term economic threat. Korea, throughout the 1990s, maintained a considerable export advantage over the Chinese in the United States and Japan. However, by 1999 the gap had closed to a \$1.9 billion advantage and \$400 million disadvantage respectively.¹¹⁸ After unification, "Korea will be faced with a flood of price-competitive Chinese manufactured goods that challenge its own firms."¹¹⁹ In the short-term, Korea's greatest competitor for low and medium technology goods is Japan, but the long-term Chinese economic threat to a unified Korea looms large.

¹¹⁶ Victor D Cha, *Alignment Despite Antagonism: The US-Korea-Japan Security Triangle* (Stanford, California: Stanford University Press, 1999), 220.

¹¹⁷ Cha, 219-221.

¹¹⁸ William Shepherd and Kwon O. Yul, eds. *Korea's Economic Prospects* (Boston, MA: Edward Elgar Publishing, Inc., 2001), 133.

¹¹⁹ Nicholas R Lardy, *China's Unfinished Economic Revolution* (Washington, DC: The Brookings Institute, 1998), 97.

V. CASE STUDY: GERMANY

The unification of Germany provides an example of unification by absorption. In this case, capitalist West Germany absorbed communist East Germany during a period of radical change. The unification of the two rival states was not seamless, but it did proceed with unprecedented speed. Numerous difficulties were encountered, but today a unified Germany boasts the third largest economy in the world and is a leading actor in the European Union (EU) and NATO. How did Germany recover from the vast problems encountered with unification? What positive steps were taken to prevent complete economic and political chaos? What mistakes were made and how could they have been prevented? How can the German example be applied to Korea? The scenario that was played out in Germany witnessed the peaceful disintegration of East Germany culminating in absorption by West Germany. In Korea, this was once the most desired and even anticipated option. However, the huge economic costs of rapid implosion have dampened South Korean enthusiasm.¹²⁰

A. CREATING TWO STATES

West Germany (Federal Republic of Germany or FRG) and East Germany (German Democratic Republic or GDR) were created much the same way that the Korean peninsula developed into two separate states. After Germany's unconditional surrender on May 8, 1945, the United States, the United Kingdom, and the USSR occupied the country and assumed responsibility for its administration. France was later given a separate zone of occupation. Although the United States, the United Kingdom, and the Soviet Union agreed at Potsdam in August 1945 to a broad program of decentralization, treating Germany as a single economic unit with some central administrative departments, these plans failed. The turning point came in 1948, when the Soviets withdrew from the four-power governing bodies and blockaded Berlin.¹²¹

¹²⁰ Kim Hyun-Dong and Jonathan D. Pollack, eds. *East Asia's Potential For Instability and Crisis: Implications for the United States and Korea* (Santa Monica, CA.: Rand Corporation, 1995), 156.

¹²¹ "Background Notes: Germany." U.S. Department of State, Bureau of European and Eurasian Affairs, July 2001: http://www.state.gov/www/background_notes.

B. WEST GERMANY

The United States and Britain moved to establish a nucleus for a future German government by creating the Central Economic Council for their two zones. The program later provided for a West German constituent assembly, an occupation statute governing relations between the Allies and the German authorities, and the political and economic merger of the French with the British and American zones. In 1949, the Basic Law, the constitution of the Federal Republic of Germany, was promulgated and formed the first federal government.¹²²

The FRG quickly progressed toward full sovereignty and association with its European neighbors and the Atlantic community. The London and Paris agreements of 1954 restored full sovereignty (with some exceptions) to the FRG in May 1955 and opened the way for German membership in the North Atlantic Treaty Organization (NATO) and the Western European Union (WEU).¹²³

The three Western allies retained occupation powers in Berlin and certain responsibilities for Germany as a whole. Under the new arrangements, the Allies stationed troops within the FRG for NATO defense, pursuant to stationing and status-of-forces agreements. With the exception of 45,000 French troops, Allied forces were under NATO's joint defense command.¹²⁴

C. EAST GERMANY

In the Soviet zone the Social Democratic Party was forced to merge with the Communist Party in 1946 to form a new party, the Socialist Unity Party (SED). The October 1946 elections resulted in coalition governments in the five Land (state) parliaments with the SED as the undisputed leader. A series of people's congresses were called in 1948 and early 1949 by the SED. Under Soviet direction, a constitution was drafted in 1949 and adopted, which was celebrated as the day when the German Democratic Republic was proclaimed. The Soviet Union and its East European allies

¹²² "Background Notes: Germany."

¹²³ CIA, *The World Factbook – Germany*. <http://www.cia.gov/publications/factbook>

¹²⁴ CIA, *The World Factbook – Germany*.

immediately recognized the GDR, although it remained largely unrecognized by noncommunist countries until 1972-73.¹²⁵

The GDR established the structures of a single-party, centralized, communist state. In 1952, the traditional *Land* was abolished and, in their place, 14 *Bezirke* (districts) were established. Effectively, all government control was in the hands of the SED, and SED members held almost all important government positions.¹²⁶

The National Front was an umbrella organization nominally consisting of the SED, four other political parties controlled and directed by the SED, and the four principal mass organizations (youth, trade unions, women, and culture). However, control was clearly and solely in the hands of the SED. Balloting in GDR elections was not secret. As in other Soviet bloc countries, electoral participation was consistently high, with nearly unanimous candidate approval.¹²⁷

D. GERMAN UNIFICATION

The constant stream of East Germans fleeing to West Germany placed great strains on FRG-GDR relations in the 1950s. In 1961, the GDR began building a wall through the center of Berlin to divide the city and slow the flood of refugees to a trickle. The Berlin Wall became the symbol of the East's political encumbrance and the division of Europe. However, in 1969, Chancellor Brandt announced that the FRG would remain firmly rooted in the Atlantic alliance but would intensify efforts to improve relations with Eastern Europe and the GDR. The FRG commenced this *Ostpolitik* by negotiating "non-aggression" treaties with the Soviet Union, Poland, Czechoslovakia, Bulgaria, and Hungary.¹²⁸

The FRG's relations with the GDR posed particularly difficult questions. Though anxious to relieve serious hardships for divided families and to reduce friction, the FRG under Brandt was intent on holding to its concept of "two German states in one German nation." Relations improved, however, and in 1973, the FRG and the GDR were

¹²⁵ Ulrich Heilenmann and Reimut Jochimsen, *Christmas in July?: The Political Economy of German Unification Reconsidered* (Washington, DC: The Brooking Institute, 1993), 12-14.

¹²⁶ Heilenmann and Jochimsen, 18-22.

¹²⁷ Manfred Gortemaker, *Unifying Germany, 1989-1990* (New York: St. Martin's Press, 1994), 10-15..

¹²⁸ Gortemaker, 27.

simultaneously admitted to the United Nations. The two Germanys exchanged permanent representatives in 1974, and, in 1987, GDR head of state Erich Honecker paid an official visit to the FRG.¹²⁹

During the summer of 1989, rapid changes took place in the GDR, which ultimately led to German unification. Growing numbers of East Germans emigrated to the FRG via Hungary after the Hungarians decided not to use force to stop them. Thousands of East Germans also tried to reach the West by staging sit-ins at FRG diplomatic facilities in other East European capitals. The exodus generated demands within the GDR for political change, and mass demonstrations in several cities continued to grow. In early October 1989, Soviet leader Mikhail Gorbachev visited Berlin to celebrate the 40th anniversary of the establishment of the GDR and urged the East German leadership to pursue reform.¹³⁰

On October 18 Erich Honecker resigned as head of the SED and as head of state and was replaced by Egon Krenz. Nevertheless, the exodus continued unabated, and pressure for political reform mounted. On November 4 a demonstration in East Berlin drew as many as 1 million East Germans. Finally, on November 9, the Berlin Wall was opened, and East Germans were allowed to travel freely. Thousands poured through the wall into the western sectors of Berlin, and on November 12, the GDR began dismantling it.¹³¹

On November 28 FRG Chancellor Kohl outlined a 10-point plan for the peaceful unification of the two Germanys based on free elections in the GDR and a unification of their two economies. In December, the GDR eliminated the SED monopoly on power, and the entire Politburo and Central Committee resigned. The SED changed its name to the Party of Democratic Socialism (PDS) and the formation and growth of numerous political groups and parties marked the end of the communist system. On December 7, 1989, agreement was reached to hold free elections in May 1990 and rewrite the GDR constitution. On January 28 all the parties agreed to advance the elections to March 18,

¹²⁹ Gortemaker,, 36-39.

¹³⁰ Leslie Lipschitz and Donogh McDonald, *German Unification: Economic Issues* (Washington, DC: International Monetary Fund, 1990), 77.

¹³¹ Gortemaker, 67-69.

primarily because of an erosion of state authority and because the East German exodus was continuing apace with more than 117,000 people leaving in January and February 1990.¹³²

In early February 1990 Chancellor Kohl, who affirmed that a unified Germany must be a member of NATO, rejected a proposal for a unified, neutral German state. Finally, on March 18, the first free elections were held in the GDR, and a government was formed under a policy of expeditious unification with the FRG. The freely elected representatives held their first session on April 5, and the GDR peacefully evolved from a communist to a democratically elected government. On July 1, the two Germanys entered into an economic and monetary union.¹³³

Conclusion of the final settlement cleared the way for unification of the FRG and GDR. Formal political union occurred on October 3, 1990, with the accession (in accordance with Article 23 of the FRG's Basic Law) of the five Leander, which had been reestablished in the GDR. On December 2, 1990, all-German elections were held for the first time since 1933.¹³⁴

1. Economic Implications

Even though great damage was inflicted on both East and West Germany during World War II, both nations had emerged as potent economies by the 1960s. West Germany became a leading economic world power in the 1970s and 1980s, and East Germany was a leader among **Warsaw Pact** economies. Unification, however, brought serious economic problems. Western Germany has had to shoulder high taxes to fund improvements in infrastructure, environment, and industry in the east, while many Eastern enterprises have collapsed in the face of Western competition.¹³⁵ Still, Germany remains a powerhouse in the world economy, with a 2000 GDP of \$1.9 trillion.¹³⁶

¹³² Gaines Post, Jr., ed. *German Unification: Problems and Prospects* (Keck Center for International and Strategic Studies: Claremont McKenna College, 2001), 96.

¹³³ Post, 104-110.

¹³⁴ Robert Corcer, et al. *United Germany: The First Five Years* (Washington, DC: International Monetary Fund, 1995), 10-12.

¹³⁵ Corcer, 25.

¹³⁶ CIA. *The World Factbook – Germany*.

The unified German economy has been marked by vulnerability to external shocks, domestic structural problems, and continued difficulties in integrating the formerly communist East into the capitalist system of the West. From the 1948 currency reform until the early 1970s, West Germany experienced almost continuous economic expansion, but real GDP growth slowed and even declined from the mid-1970s through the recession of the early 1980s.¹³⁷ The economy then experienced eight consecutive years of growth that ended with a downturn beginning in late 1992. Since unification in 1990, Germany has seen annual average real growth of only about 1.5 percent coupled with stubbornly high unemployment.¹³⁸ The best performance since unification was registered in 2000, when real growth reached 3.0 percent. Most forecasters expect growth of about 1.5 percent in 2001 while unemployment remains above 9 percent.¹³⁹

Ten years after the unification of the two German states, significant progress has been made in raising the standard of living in eastern Germany, introducing a market economy and improving infrastructure there. At the same time, the process of convergence between East and West is taking longer than originally expected, and on some measures, has stagnated since the mid-1990s. Eastern economic growth rates have been slower than in the West in recent years, unemployment is twice as high, prompting many skilled easterners to seek work in the West, and productivity continues to lag.¹⁴⁰ Eastern consumption levels are dependent on public net financial transfers from West to East, totaling about \$65 billion per year, or about 4 percent of the GDP of western Germany. In addition to social assistance payments, the government plans to extend funds to promote eastern economic development through 2019.¹⁴¹

While unification brought together long-separated families and friends, it also brought numerous economic and social problems to Germany, including housing shortages, strikes and demonstrations, unemployment, and increases in crime and right-wing violence against foreigners. Budget deficits caused by unification, and worsened by a recession, have led to increased taxes, reduced government subsidies and increased

¹³⁷ Heilenmann and Jochimsen, 36.

¹³⁸ Post, 121.

¹³⁹ The International Monetary Fund (IMF). Country Information – Germany. <http://www.imf.org/external/country>.

¹⁴⁰ CIA. *The World Factbook – Germany*.

¹⁴¹ IMF. *Country Information – Germany*.

privatization, and cuts in social services.¹⁴² While increasing the market for consumer products, unification has significantly affected the strength and competitiveness of the German economy. Even after more than ten years since the two German states unified, a recognizable gulf is evident between the two Germanys in standards of living, industrial performance, and infrastructure.¹⁴³

2. Similarities to Korea

The German unification scenario does share some important similarities with Korea. North Korea, like East Germany, enjoyed a period of independent economic success despite disadvantageous external conditions. The East Germans were also strongly supported by the Soviets and the other East European communist nations. North Korea enjoyed the same support until the end of the Cold War. South Koreans, like the West Germans, feel that their democratic and capitalist system must be adopted in a unified nation, and the other side must reform in order for unification to be possible. Although analysts acknowledge this dimension of the German unification process, it is consistently underplayed in favor of greater attention to the anticipated economic costs of Korean unification.

The economic dimensions of the former FRG compared to the former GDR somewhat resemble South Korea compared to North Korea. At the time of unification in 1990, the FRG 's GDP was roughly ten times that of the GDR's.¹⁴⁴ That same year, South Korea enjoyed a similar advantage. However, since 1990, the South Korean economy has grown to nearly twenty times that of the North, partly because of the North's consecutive years of negative growth and lack of foreign aid. At the end of 1991, about a year after unification, the East German GDP was \$60.2 billion, while the West German GDP was \$1.28 trillion.¹⁴⁵ Thus, the East only represented about 8.3 percent of the West's economy. Today, more than ten years later, little parity has been reached and West Germany is still far stronger the East economically. This same scenario may play

¹⁴² Post, 201-203.

¹⁴³ CIA. The World Factbook – Germany.

¹⁴⁴ Lipschitz and McDonald, 188.

¹⁴⁵ Leif Roderick Rosenberger, "How German Unification Mistakes Damage West European Economies" (Carlisle, PA: Strategic Studies Institute, U.S. Army War College, 1993), 21-24.

out in the case of Korea because of the many years in which the North neglected its economic infrastructure, while the South flourished.

It is important to note that East Germany was much less isolated and more interdependent than North Korea is today. In any event, East Germans had much more contact with both Western nations and more progressive socialist countries, like Hungary, that had already commenced political and economic reform.¹⁴⁶ Although North Korea shares a border with one of the more democratic societies in East Asia, any calls for reform would be made within the vacuum of the current regime's self imposed isolation.

Compared to Germany prior to its unification, North and South Korea do not possess as great a disparity in population size. Whereas West Germany's population was five times that of East Germany, South Korea's is only twice that of North Korea. Thus, there will be proportionally fewer South Koreans to support a potentially destitute northern population. Assimilating a population half its size into its limited social security framework will be a difficult task. Furthermore, South Korea's social welfare system is far less extensive than Germany's characteristically generous Western European model, so the overall expenditure requirements could be less.¹⁴⁷

German unification, in many ways, differs from the circumstance present in Korea and gives rise to the argument that absorption is not the favored scenario in Korea's case. First, German unification was literally the result of chance, not natural or incremental unification as proposed by the theory of "peace through pieces." Chance unification in Korea is not likely to happen and would likely bring about the most chaotic of consequences. Second, The pre-unification excitement in Germany was quickly replaced by post-unification despair. A unified Germany witnessed an unprecedented rise in unemployment, social alienation, and domestic unrest. In Korea, hope and desire for unification is varied and diverse largely because the cost estimates of unification. The North's extremely dire economic conditions predict that the social conditions following unification will be extremely dire and extensive in scope. Last, post-unification Germany did not experience a rise in nationalism and national identity and therefore did not have a

¹⁴⁶ Heilenmann and Jochimsen, 19.

¹⁴⁷ Song Byung-Nak, *The Rise of the Korean Economy*, Second Edition (New York: Oxford University Press, 1997), 155.

solid domestic foundation with which to begin reconstruction. Although ethnically unified, the Korean peninsula is heavily fractionalized and politically fragile. Therefore it does not invoke the confidence of creating a solid national identity following unification, regardless of the means.¹⁴⁸

The unification of Korea, apart from the vast political and social problems to be encountered, would inflict larger relative cost burdens on South Korea and its allies than have occurred in the German example. Charles Wolf gives two examples of disparity that support this argument. First, “the population of North Korea compared with the South (about one half) is twice as large as that of East Germany compared with West Germany.” Second, “per capita GDP in North Korea relative to South Korea is probably much lower (perhaps one-fifth to one-sixth) compared to that between East Germany and West Germany in 1990.”¹⁴⁹

However, Wolf also points to two examples of how the Korean situation is positively unique from the German example.

- First, “the economic burden on North Korea from its relatively huge military establishment is enormously greater in relative terms than were the costs of the German Democratic Republic (GDR) military establishment preceding German reunification. In North Korea the military establishment absorbs somewhere between 20 and 40 percent of the North Korean GDP, probably closer to the upper end of this range.”¹⁵⁰
- Second, “in contrast, in East Germany the military establishment was predominantly that of the Soviet Union. Although still imposing a burden on the GDR economy, most of the total costs were borne by the Soviet Union, while only a fraction of the proportion mentioned above was imposed on the GDR.”¹⁵¹

Thus, shrinking the military establishment on both sides would substantial savings diminishing the South Korean financial burden.

¹⁴⁸ Samuel S Kim, “The Future of the Post-Kim Il Sung System in North Korea,” 51-52.

¹⁴⁹ Charles Wolf, “Forecasting Korea’s Economy and the Costs of Reunification,” in *Patterns of Inter Korean Relations*. Eds. Bae Ho Hahn and Chae-Jin Lee (Seoul: Sejong Institute, 1999), 178.

¹⁵⁰ Wolf, “Forecasting Korea’s Economy and the Costs of Reunification,” 179.

¹⁵¹ Wolf, “Forecasting Korea’s Economy and the Costs of Reunification,” 180.

E. LESSONS LEARNED

Although the main concern of unification is the political union of the Korean peninsula, German unification sheds more light on the importance of economic exchanges and cooperation. Non-commercial exchanges or grants under favorable conditions are especially important for reducing political as well as economic confrontation. The West German people had to bear a heavy economic and financial burden of unification, similar to what South Korea will likely encounter. In the five years following German unification, its government poured \$600 billion of public money into developing the East.¹⁵² That figure exceeds five percent of German GDP for that same period. Even if Korea's tab is smaller, it could represent a greater share of its GDP.

The German unification effort was hampered by two glaring errors that need not be repeated in Korea. One mistake that drastically increased the expense of German unification was the decision to permit a generous 1:1 exchange of East German Ostmarks for West German Deutschmarks. Ostmarks had traded at a 4:1 ratio prior to unification.¹⁵³ The generous exchange rate provided some short-term benefits by spurring consumption in the East and fostering eastern goodwill. However, East German wages did not remain low in real terms and the eastern economy proved not to be competitive.

After unification, West German trade unions fought successfully to raise the pay of East German workers to a level closer to that of West German workers. This raise occurred despite the glaring productivity gap between workers in the two regions. The impact on German industry in the East was decidedly negative. The increase in labor costs made unemployment soar and discouraged foreign investment at a time when Germany needed it most to meet the costs of unification.¹⁵⁴

The ROK could offer a generous but not ridiculously high conversion rate for the North Korean won. Currently the North Korean won is pegged to the U.S. dollar at about 2.2:1.¹⁵⁵ However, it is not a convertible currency. It is highly unlikely that it would trade

¹⁵² Corcer, 74.

¹⁵³ Corcer, 121.

¹⁵⁴ Post, 89.

¹⁵⁵ Lipschitz and McDonald, 165.

at anywhere near that rate on the open market. One exchange option is to use the black market rate as a guideline when one emerges in the immediate wake of unification.¹⁵⁶ In any event, the impact on the South Korean won will be minimal because North Koreans probably hold little hard currency as a result of periodic official currency sweeps conducted to flush out illegally earned cash.¹⁵⁷

In determining a rate of exchange, both the state of the North Korean economy and the level of inflationary pressure in the South would have to be considered. A generous rate could have the desired effects of both spurring consumption in the North and fostering goodwill toward the ROK government and the South in general. It could also alleviate Northerners' fear of being "absorbed" by the South. In the short term, it could ease the transition of Northerners into an economy where the quantity, quality and cost of goods are significantly higher than those to which they are accustomed. That action taken alone, while keeping wages in the North at levels commensurate with productivity, could ease the pain of economic restructuring and keep unification costs at more moderate levels compared to Germany, while at the same time encouraging much needed foreign investment.¹⁵⁸

The effort to return property expropriated by the former Communist government to its rightful owners or heirs proved to be another expensive policy of German unification. This raised the price tag on unification both directly and indirectly. The bureaucracy necessary for researching and documenting title to seized or transferred properties was considerable. Those cases where title was in dispute resulted in a drain on a court system already burdened by the difficulties of unification. In addition, the specter of questionable property titles delayed the privatization of East German government property, slowing the pace of investment.¹⁵⁹

Because the East German people were not accustomed to the free market system, they were forced into a difficult transition process, along with experiencing psychological frustration and unemployment. Through the transition process they had to overcome

¹⁵⁶ Noland, *Economic Integration of Korean Peninsula*, 111.

¹⁵⁷ Henriksen and Mo, 135.

¹⁵⁸ Eberstadt, "Economic Recovery in the DPRK: Status and Prospect," 19.

¹⁵⁹ Corcer, 38.

many conflicts on the issue of equity and property ownership.¹⁶⁰ The same scenario will likely play out in Korea as the communist North Koreans become immersed into a capitalist system. This scenario can be reduced greatly, or even avoided, with increased economic cooperation and market-based reform prior to unification.

Germany did unify peacefully, but does *Ostpolitik* deserve the credit for leading the two Germanys to political rapprochement? The policy stressed “liberalization through stabilization” with heavy emphasis on expanding trade and economic assistance from the West to the East. However, looking back following unification, *Ostpolitik* may have increased tensions between the two and may have led to many of the economic problems encountered following unification. Studies released shortly after unification show that East Germany’s military posture and aggressiveness toward the West was increased following the inception of *Ostpolitik*, vice being relaxed as previously believed. Economically, Eastern authorities abused the import of goods and products from the West by using them not as compliments to reform, but as substitutes. Ideologically, it has been discovered that Eastern state officials launched numerous programs in response to *Ostpolitik* in order to counter peaceful coexistence and further entrench the socialist ideology. Regardless, peaceful unification did take place, but is credited by some studies as being the result of a lack of independence on behalf of the East within the international community. The East only began to fall after Moscow declared that it would no longer support the East’s struggles with domestic issues. Under that pressure, the Eastern regime began to fail and reached toward the West as a result.¹⁶¹

Research from the Korean Development Institute, one of Seoul’s most prominent economic think tanks, asserts “the German experience demonstrates that national unification involves enormous costs, and, going forward, this is probably the most critical concern for South Korea.”¹⁶² It also reported “the experience of German national unification convinced a large number of South Koreans that sudden economic integration in Korea...will result in disaster.”¹⁶³

¹⁶⁰ Corcer, 43.

¹⁶¹ Eberstadt, *The End of North Korea*, 78-80.

¹⁶² Eberstadt, *The End of North Korea*, 125.

¹⁶³ Eberstadt, *The End of North Korea*. 136.

Selig Harrison notes the positive impact that prior economic cooperation, through *Ostpolitik*, had in the case of German unification.

“It was the network of contacts and economic linkages between East and West Germany made possible by *Ostpolitik* over a twenty-five year period that set the stage for the upheaval triggered in the East by Gorbachev’s relaxation of the Soviet grip.”¹⁶⁴

It is further pointed out that the bulk of the cost of unification came in the form of social welfare payments. The high costs of unification were incurred through a collision between generous wage increases and new social insurance system.¹⁶⁵

¹⁶⁴ Selig Harrison, “The United States and the Future of Korea,” in *The Two Koreas And The United States: Issues of Peace, Security, and Economic Cooperation*. ed. Wonmo Dong (New York: M. E. Sharpe, 2000), 202.

¹⁶⁵ Harrison, Selig, “The United States and the Future of Korea,” 128.

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VI. CASE STUDY: YEMEN

The unification of Yemen, although small in scale, is an example of unification by negotiation. Two separate Yemeni states were created out of an artificial division by foreign influence in the region centuries before unification. Only after the foreign umbrella was removed did regional leaders formally create separate states based on ideological differences. Nevertheless, after nearly twenty years of negotiation and often sporadic fighting, Yemen unified. For nearly a century, Yemen has been a battlefield, with separatist groups vying for control of the different regions within the country. The fighting did cease in early 1990 when unification was ratified, but escalated into a civil war just four years after unification. Unlike Germany and Korea, Yemen is an extremely poor state and has not received much international attention or aid during its unification process.

A. NORTH YEMEN

North Yemen was a colonial state of the Ottoman Empire since the 16th century. Ottoman control of northern Yemen finally ended when Turkish forces withdrew from the area in 1918. Indigenous rule was then restored, as tribal leader Imam Yahya strengthened his control over north Yemen following the Turkish withdrawal. Yemen became a member of the Arab league in 1945 and the United Nations in 1947. Imam Yahya died during an unsuccessful coup attempt in 1948 and was succeeded by his son Ahmad, who ruled until his death in September 1962. Shortly after assuming power in 1962, Ahmad's son, Badr, was deposed by revolutionary forces, which took control of the capital city of Sanaa and created the Yemen Arab Republic (YAR). Egypt assisted the YAR with troops and supplies to combat forces loyal to Badr. Saudi Arabia and Jordan supported Badr's royalist forces to oppose the newly formed republic. Conflict continued periodically until 1967, when Egyptian troops were withdrawn. By 1968, following a

final royalist siege of Sanaa, most of the opposing leaders reached reconciliation and Saudi Arabia recognized the Republic in 1970.¹⁶⁶

B. SOUTH YEMEN

The British successfully captured the southern port city of Aden in 1839, and thus assumed the colonial rule of South Yemen as part of British India until 1937. At that time Aden was made a crown colony, with the remaining land designated as east Aden and west Aden protectorates.¹⁶⁷

By 1965, most of the tribal states within the protectorates and the Aden colony proper had joined to form the British-sponsored Federation of South Arabia. In 1965, two rival nationalist groups, the Front for the Liberation of Occupied South Yemen (FLOSY) and the National Liberation Front (NLF), turned to terrorism in their struggle to control the country. In 1967, in the face of uncontrollable violence, British troops began withdrawing, federation rule collapsed, and NLF elements took control after eliminating their FLOSY rivals.¹⁶⁸

South Arabia, including Aden, was declared independent on November 30, 1967, and was renamed the People's Republic of South Yemen. In June 1969, a radical wing of the Marxist NLF gained power and later changed the country's name on December 1, 1970, to the People's Democratic Republic of Yemen (PDRY). In the PDRY, all political parties were combined into the Yemeni Socialist Party (YSP), which became the only legal party. The PDRY established close ties with the Soviet Union, China, Cuba, and radical Palestinians.¹⁶⁹

C. YEMENI UNIFICATION

In 1972, the governments of the PDRY and the YAR declared that they approved a future union. However, little progress was made toward unification, and relations were

¹⁶⁶ Almadhagi, Ahmed and Noman Kassim, *Yemen and the United States : A Study of A Small Power and Super-State Relationship, 1962-1994*. (New York : Tauris Academic Studies, I.B., Tauris Publishers, 1996) 2-25.

¹⁶⁷ Pelletiere, Stephen C. *Yemen and Stability in the Persian Gulf : Confronting the Threat From Within*. (Carlisle Barracks, PA: Strategic Studies Institute, U.S. Army War College, 1996), 4-8.

¹⁶⁸ Pelletiere, 130.

¹⁶⁹ Pelletiere, 34-39.

often strained. In 1979, simmering tensions led to fighting, which was only resolved after Arab League mediation. The northern and southern heads of state reaffirmed the goal of unity during a summit meeting in Kuwait in March 1979. The border wars between the two countries in 1972 and 1979 both had ended surprisingly with agreements for Yemeni unification, though in each case the agreement was quickly shelved.¹⁷⁰

Relations between the YAR and PDRY grew increasingly conciliatory after 1980. During the 1980s, the two countries cooperated increasingly in economic and administrative matters. However, in 1986 the fighting resumed as a violent struggle among factional leaders for regional dominance in Aden. Fighting lasted for more than a month and resulted in thousands of casualties.¹⁷¹

In May 1988, the YAR and PDRY governments came to an understanding that considerably reduced tensions, including agreement to renew discussions concerning unification, to establish a joint oil exploration area along their undefined border, to demilitarize the border, and to allow Yemenis unrestricted border passage on the basis of only a national identification card. In December 1989, their respective leaders met and prepared a final unification agreement. On May 22, 1990, North and South Yemen officially merged to become the Republic of Yemen. A 30-month transitional period for completing the unification of the two political and economic systems was set in motion.¹⁷²

1. Civil War

In May 1991 the populace ratified the unity constitution, which had been agreed upon in May 1990,. It affirmed Yemen's commitment to free elections, a multiparty political system, the right to own private property, equality under the law, and respect of basic human rights. Parliamentary elections were held on April 27, 1993. International groups assisted in the organization of the elections and observed actual balloting. However, conflicts within the coalition resulted in the self-imposed exile of the vice

¹⁷⁰ Charles Dunbar, "The Unification of Yemen: Process, Politics, and Prospects," *Middle East Journal*, 46/3 (1992), 13.

¹⁷¹ Charles Dunbar, "The Unification of Yemen: Process, Politics, and Prospects," 48.

¹⁷² Burrowes, Robert D. "The Republic of Yemen: A Case of Political Unification in Process, 1989-1992," *The Symposium on Arab Integration*, Center for Contemporary Studies (Washington, DC: Georgetown University, April 1992), 17.

president and deterioration in the general security situation, as political rivals settled scores and tribal elements took advantage of the unsettled situation. Continuous negotiations between northern and southern leaders resulted in the signing of the document of pledge and accord in Amman, Jordan on February 20, 1994. Despite this, clashes intensified until civil war broke out in early May 1994.¹⁷³

Almost all of the actual fighting in the 1994 civil war occurred in the southern part of the country despite air and missile attacks against cities and major installations in the north. Southerners sought support from neighboring states and received billions of dollars of equipment and financial assistance. Southern leaders declared secession and the establishment of the Democratic Republic of Yemen (DRY) on May 21, 1994, but the international community did not recognize the DRY. The northern forces greatly increased military operations against the secessionists and Aden was captured on July 7, 1994. Other resistance quickly collapsed and thousands of southern leaders and military went into exile. Amendments to the unity constitution were quickly adopted that would alleviate conflict and strife and include greater cooperation among tribal and factional leaders allowing fair and equal participation in the government.¹⁷⁴

2. Economic Implications

At unification, both the YAR and the PDRY were struggling, underdeveloped economies. In the north, disruptions of civil war (1962-70) and frequent periods of drought had dealt severe blows to a previously prosperous agricultural sector. Coffee production, formerly the north's main export and principal form of foreign exchange, declined as well during the period. Low domestic industrial output and a lack of raw materials made the YAR dependent on a wide variety of imports.¹⁷⁵

Remittances from Yemenis working abroad and foreign aid paid for perpetual trade deficits. Substantial Yemeni communities exist in many countries of the world, including Yemen's immediate neighbors on the Arabian Peninsula, Indonesia, India, East

¹⁷³ Michael C Hudson, *Regional Integration in the Arab World: Problems of Political and Economic Fragmentation*. Columbia University Press: New York, 1998. p. 70-77.

¹⁷⁴ Hudson., 90-92.

¹⁷⁵ Carapico, Shelia. "The Economic Dimensions of Yemeni Unity," *Middle East Report*, 184, (Sept/Oct 1993), 58.

Africa, the United Kingdom, and the United States. Beginning in the mid-1950s, the Soviet Union and China provided large-scale assistance to the YAR. This aid included funding of substantial construction projects, scholarships, and considerable military assistance.¹⁷⁶

In the south, pre-independence economic activity was overwhelmingly concentrated in the port city of Aden. The sea borne transit trade, which the port relied upon, collapsed with the closure of the Suez Canal and Britain's withdrawal from Aden in 1967. Only extensive Soviet aid, remittances from south Yemenis working abroad, and revenues from the Aden refinery (built in the 1950s) kept the PDRY's centrally planned Marxist economy afloat. With the dissolution of the Soviet Union and a cessation of Soviet aid, the south's economy basically collapsed.¹⁷⁷

Since unification, the government has worked to integrate two relatively disparate economic systems. By the summer of 1990, rising oil revenues and financial assistance from many foreign countries, including Iraq, Saudi Arabia, and the United States, brought hope that Yemen could begin to strengthen and expand its economy. However, Iraq's invasion of Kuwait in 1990 and the events that followed in the Persian Gulf took a serious toll on Yemen's economy and newfound political stability. Yemen's critical response to the presence of foreign military forces massed in Saudi Arabia led the Saudi government to expel 850,000 Yemeni workers; the return of the workers and the loss of remittance payments produced widespread unemployment and economic upheaval, which led in turn to domestic political unrest.¹⁷⁸

Bomb attacks, political killings, and violent demonstrations occurred throughout 1991 and 1992. Then in December 1992 a rise in consumer prices precipitated riots in several of Yemen's major cities. Concern arose that declining economic and social conditions would give rise to Islamic fundamentalist activities in Yemen. Political

¹⁷⁶ Hudson, 48.

¹⁷⁷ Braun, Ursula. "Yemen: Another Case of Unification," Aussenpolitik, 11 (1992)

¹⁷⁸ Braun.

turmoil forced the government to postpone general elections, which were finally held on April 27, 1993, completing the Yemeni unification process begun three years earlier.¹⁷⁹

After the 1994 civil war, the Yemeni government was faced with the task of rebuilding Yemen's economy and government. The infrastructure in and around Aden sustained the most damage, from water systems to oil refineries and communications centers. In July more than 100 cases of cholera were diagnosed in Aden, due in part to water shortages in the city. In an attempt to revive the country's economy, Yemeni leaders made efforts to devise and implement an economic austerity program called for by several international economic agencies; this was achieved with a great deal of difficulty in the spring of 1995.¹⁸⁰

Since the conclusion of the civil war, the government entered into agreement with the International Monetary Fund (IMF) to institute an extremely successful structural adjustment program. Phase one of the IMF program included major financial and monetary reforms, including floating the currency, reducing the budget deficit, and cutting subsidies. Phase two will address structural issues such as civil service reform.¹⁸¹ The World Bank also is active in Yemen, providing an \$80-million loan in 1996.¹⁸² Yemen has received debt relief from the Paris Club. Some military equipment is still purchased from former East bloc states and China, but on a cash basis. As a sign of growing economic recovery following unification and civil war, Yemen's oil exports in 1995 earned about \$1 billion and rose to nearly \$2 billion in 2000.¹⁸³

D. LESSONS LEARNED

Socialist South Yemen and capitalist North Yemen accomplished their unification through peaceful negotiations. Yemen achieved its unification without military conflict, although bloodshed was a historical norm prior to serious unification negotiations. The

¹⁷⁹ "Background Notes: Yemen." U.S. Department of State, Bureau of Near Eastern Affairs, January 2002: http://www.state.gov/www/background_notes.

¹⁸⁰ Carapico, Sheila. Civil Society in Yemen : *The Political Economy of Activism in Modern Arabia* (New York : Cambridge University Press, 1998), 39-47.

¹⁸¹ The International Monetary Fund (IMF). Country Information – Yemen, Republic of. <http://www.imf.org/external/country>.

¹⁸² The World Bank Group. "Yemen," Country Report. <http://www.worldbank.org/>.

¹⁸³ CIA. The World Factbook – Yemen. <http://www.cia.gov/publications/factbook>.

Yemeni example shows the possibility that peaceful negotiations can solve very difficult political issues. However, Yemen failed to prevent a civil war after it was politically unified because it was unified hastily and superficially without having experienced a process of real reconciliation and cooperation. Yemen provides the lesson that unification without accumulated social, economic and political integration may bring inefficient results, as shown by the outbreak of civil war in Yemen just four years after unification.

Although the strategic setting in Yemen is far different from Korea, Yemen's unification process provides a grim example of the potential violence that can result from an attempt to prematurely merge two nations whose political systems are diametrically opposed. Considering Yemen's experience, Kim Dae-jung's "Sunshine policy" and the slow approach of incremental and gradual unification seem prudent choices. As far as economics are concerned, the lessons learned are those of lost opportunity. Today, it seems Yemen is on the right track to economic recovery. However, prior concentration on an economic union could have overshadowed political difference and the economic advantages of unification could have created unity without bloodshed.

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VII. CASE STUDY: CHINA

In late 1978, the Chinese leadership began moving the economy from a sluggish centrally planned system to a market-oriented system. Since then, China has adopted a pragmatic perspective on many political and socioeconomic problems and has sharply reduced the role of ideology in economic policy. Political and social stability and economic productivity are considered paramount. The government has emphasized raising personal income and consumption and introducing new management systems to help increase productivity. The government also has focused on foreign trade as a major vehicle for economic growth.

However, the Chinese economic system operates within a political framework of strict Chinese communist control, but the economic influence of non-state managers and enterprises has been steadily increasing. The authorities have switched to a system of household responsibility in agriculture in place of the old collectivization, increased the authority of plant managers in industry, permitted a wide variety of small-scale enterprise in services and light manufacturing, and opened the economy to increased foreign trade and investment. The result has been a quadrupling of GDP since 1978.

A. DENG XIAOPING'S REFORMS

Chairman Mao Zedong led communist China from its inception in 1949, when his communist forces defeated the nationalist and formed the People's Republic of China (PRC), until his death in 1976. Under his leadership, the PRC economy was completely collectivized under the mantle of Marxist-Leninist ideology, but with Chinese characteristics. However, Mao's effort to communize China economically had serious social consequences. Numerous programs enacted under Mao's leadership made the later reform effort much more difficult. .

In 1978, the PRC President Deng Xiaoping re-established power and implemented his "four modernizations" in agriculture, industry, science and technology, and national defense. China developed from an agrarian economy into an industrial powerhouse. This growth is one of the greatest economic phenomena of the twentieth

century, rivaling the United States' emergence in the early part of the century and the post World War II recoveries of Japan and Germany.¹⁸⁴

China's economic growth that followed stemmed from reforms that include a combination of large capital investments, both from international and domestic sources; an increasingly productive labor force; and market oriented changes that increase profit incentives. These factors combine to give China positive long-term prospects. In the two decades that followed Deng's reform movement began, the Chinese economy grew at a rate of roughly 9 percent per year.¹⁸⁵

The first phase of Deng's reform (1978-1983) movement was designed to counter existing institutional factors that inhibited productivity. The significant reforms adopted include:

- Land leased to farmers under the household responsibility system.
- Higher procurement prices for key crops.
- Introduction of the two-track price system.
- Attract foreign investment.
- Promote exports.
- Scale back the planning system for state owned enterprises (SOEs).
- Link bonuses more closely to performance.
- Establish tighter links between wages and productivity.

The agricultural sector was the jumping off point for PRC reforms. This area was underdeveloped in 1978 and offered a prime opportunity for quick results. Increases in agricultural efficiency would also generate required savings rates and provide a source of surplus labor from displaced farm workers. Initial agricultural reforms were successful, increasing both total output and productivity.¹⁸⁶

In addition, Deng initiated an "open" policy, establishing special economic zones (SEZ's) to stimulate trade with foreign markets. In these zones ownership, tax,

¹⁸⁴ Greg Mastel, *The Rise of the Chinese Economy, The Middle Kingdom Emerges*, (New York: M. E. Sharpe, inc., 1977), 9

¹⁸⁵ Organization for Economic Cooperation and Development (OECD), *China in the 21st Century Long-term Global Implications* (1996), 3.

¹⁸⁶ "China," *Oxford Review of Economic Policy*, Vol. 11 No. 4 (Winter 1995), 6.

investment, material, and wage policies were instituted that would make the areas receptive to Foreign Direct Investments (FDI). There was also a reallocation of resources, which emphasized the profitable consumer-goods industries instead of the input-intensive heavy industry. This produced an increase in manufacturing productivity and bolstered the consumer goods available. The growth experienced in the first phase of reforms was consumption led, as the consumer goods sector showed quick returns based on the short time from production to consumption.¹⁸⁷

The second phase of Deng's reform effort (1984-1991) was marked by a shift to reforms in the urban sector and industry, which took advantage of the increased savings and surplus labor that resulted from the rural reforms. Some of the significant reforms include:

- Grant SOEs more autonomy in production/employment decisions.
- Extensions of two-track system to industrial prices.
- Other types of enterprises (such as urban collectives) gain importance.
- Bank reform, including the establishment of the People's Bank as the central bank.
- Enterprises could retain larger share of profits.
- Enterprise tax introduced to replace profit transfers.
- Number of SEZ's expanded.
- Foreign trade plan scaled back.
- Swap centers for the trading of retained exchange.
- Further increases in decentralization.

These reforms led to average annual rates of growth of 10 percent in agricultural and industrial output. Rural per capita real income doubled. China became self-sufficient in grain production; rural industries accounted for 23 percent of agricultural output, helping absorb surplus labor in the countryside. The variety of light industrial and consumer goods increased. Reforms began in the fiscal, financial, banking, price setting, and labor systems.¹⁸⁸

¹⁸⁷ "China," 8.

¹⁸⁸ Nicholas Lardy, "China and the Asian Contagion," *Foreign Affairs* (Jul/Aug 1998), 16.

The second phase's reforms marked a drastic increase in growth of the non-state sector and with it came increased overall economic growth. This growth brought about a decrease in macroeconomic controls and, in turn, increased inflationary pressures usually associated with an overheating economy. This brought on the need for reforms designed to improve the financial infrastructure. In addition, a "rectification" period saw the slowing of reforms designed to lessen inflationary pressures.

The third phase of Deng's reform effort (since 1992) was marked with reforms in foreign trade, taxation and investment. This represented a significant shift away from a planned system in favor of a market economy. The major area of focus however, was in policy concerning SOEs. The system of contracting for SOEs was modernized to increase efficiency. The significant reforms adopted include:

- Market forces dedicated to playing a primary role in resource allocation.
- Strengthen and develop infrastructure for better macroeconomic control.
- Widening central bank reforms.
- Widening of financial sectors.
- Fiscal system improved.
- Exchange and trade system improved.
- Accelerate SOE reforms.

China's economy gained substantial momentum in the early 1990s. During a visit to southern China in early 1992, Deng made a series of political pronouncements designed to reinvigorate the process of economic reform. The 14th Party Congress later in the year backed Deng's renewed push for market reforms, stating that China's key task in the 1990s was to create a "socialist market economy." The 10-year development plan for the 1990s stressed continuity in the political system with bolder reform of the economic system.¹⁸⁹

During 1993, output and prices were accelerating, investment outside the state budget was soaring, and economic expansion was fueled by the introduction of more than 2,000 SEZ's and the influx of foreign capital that the SEZ's facilitated. Fearing hyperinflation, Chinese authorities called in speculative loans, raised interest rates, and

¹⁸⁹ Lardy, "China and the Asian Contagion," 24.

re-evaluated investment projects. The growth rate was thus tempered, and the inflation rate dropped from over 17 percent in 1995 to 8 percent in early 1996. In 1996, the Chinese economy continued to grow at a rapid pace, at about 9.5 percent, accompanied by low inflation. The economy slowed for the next 3 years, with official growth of 8.9 percent in 1997, 7.8 percent in 1998 and 7.1 percent for 1999. The year 2000 showed a modest reversal of this trend. Gross domestic product in 2000 grew officially at 8.0 percent that year.¹⁹⁰

B. SOURCES OF GROWTH IN THE PRC ECONOMY

Agricultural growth provided a larger portion of non-state sector growth from 1978 to 1984 than from 1984 to 1993. This is indicative of a one-time boost in productivity experienced in the first years after reforms established household farming units.¹⁹¹ During the pre-reform period, a significant amount of the agricultural labor was underemployed. This is significant because as workers moved into the industry and service sectors their activities became a more important source of productivity growth. In 1978, agricultural employment was more than 70 percent of the workforce, this fell to 54 percent in 1994.¹⁹² This shift enabled a dramatic rise in the number of non-state enterprises over the reform period. Tens of millions of the displaced workers moved to the value added manufacturing sector where they were more productive. China's non-state sector of the economy grew much faster than the state sector, which is comprised of many SOEs.

The establishment of SEZ's attracted large amounts of FDI, which had been almost zero in the pre-1979 period. By 1994, cumulative FDI reached \$95.6 billion.¹⁹³ Furthermore, the joint ventures and foreign owned enterprises received significant technological and managerial expertise spillover from outside of the system. These ventures produced items that transferred China into an export powerhouse. This indicates

¹⁹⁰ Joe Studwell, *The China Dream: The Quest for the Last Great Untapped Market on Earth* (San Francisco: Publishers Group West, 2002), 109-111.

¹⁹¹ Jeffrey Sachs and Wing Thyee Woo, "Understanding China's Economic Performance," *National Bureau of Economic Research Working Paper* 5935, 10.

¹⁹² Zulu Hu and Mohsin Khan, "Why is China Growing So Fast?" *IMF Working Paper* (IMF, July 1996), 14.

¹⁹³ Studwell, 183.

that the PRC economy was in a position for reforms to increase productivity and to spur growth. Beyond privatization and agricultural reform, China experienced considerable growth in the export sector. This is similar to models of other Asian countries. The export sector optimized the growing liberalization of China's private enterprise, since many exports come from the non-state sector. Exports from private enterprises were often financed with foreign investment.¹⁹⁴

It is important to note that PRC economic growth increased immediately after the initiation of reforms. Credit is given to foreign trade the gradual pace of program implementation helped the move toward privatization, fostering competition and therefore, efficiency. While increases in labor and capital inputs did contribute significant growth during the reform period, the largest portion of growth was caused by increases in productivity.

In addition, China has taken steps to decentralize its foreign trading system and integrate itself into the world trading system. In November 1991, China joined the Asia Pacific Economic Cooperation (APEC) group, which promotes free trade and cooperation in the economic, trade, investment, and technology spheres. China formally joined the WTO in December 2001. Accession marks the end of a 16-year cycle of negotiations. As part of this far-reaching trade liberalization agreement, China agreed to lower tariffs and abolish market impediments after it joins the WTO. Chinese and foreign businessmen, for example, will gain the right to import and export on their own, and to sell their products without going through a government middleman.¹⁹⁵

Opening to the outside remains central to China's development. Foreign-invested enterprises produce about 45 percent of China's exports, and China continues to attract large investment inflows. Since 1992, China has been the world's second-largest recipient of foreign direct investment after the United States. Foreign exchange reserves totaled about \$165 billion in 2000.¹⁹⁶

¹⁹⁴ Hu and Kahn, 65.

¹⁹⁵ Studwell, 97.

¹⁹⁶ Studwell, 225.

C. LESSONS LEARNED

Since the economic reform movement began in the late 1970s, China has achieved tremendous economic successes. From 1979 until 1992, China's economy grew at an average rate of 9 percent, reaching as high as 12 percent.¹⁹⁷ In 2000, with its 1.26 billion people but a GDP of just \$3,600 per capita, China stood as the second largest economy in the world after the US (measured on a purchasing power parity basis).¹⁹⁸ Agricultural output doubled in the 1980s, and industry also posted major gains, especially in coastal areas near Hong Kong and opposite Taiwan, where foreign investment helped spur output of both domestic and export goods. On the darker side, the leadership has often experienced in its hybrid system the worst results of socialism (bureaucracy and lassitude) and of capitalism (windfall gains and stepped-up inflation). Beijing thus has periodically backtracked, retightening central controls at intervals.

1. Similarities To Korea

The World Bank produced a 1992 report that outlined China's economy before Deng Xiaoping's 1978 reforms. The report noted that the PRC system at this time was atypical of the standard Soviet model and other reforming socialist systems. The most important differences were in the areas of health and education. This gave the PRC an advantage that would make the difference between PRC growth and the Soviet bloc's problems in the decades to follow. Furthermore, the World Bank noted that China was not in a position of macroeconomic financial crisis in 1977 "which removed the need for a strong dose of deflationary policy to accompany the launching of reforms."¹⁹⁹ This is a striking difference to the situation that exists in North Korea today.

Nicholas Eberstadt further points out some of the key differences between the Chinese reform effort and the current outlook for North Korea.

¹⁹⁷ "Background Notes: China (PRC)." U.S. Department of State, Bureau of East Asia and the Pacific Affairs (January 2002), http://www.state.gov/www/background_notes.

¹⁹⁸ CIA. *The World Factbook – China*. <http://www.cia.gov/publications/factbook>.

¹⁹⁹ "China Reform and the Role of the Plan in the 1990s" *World Bank Country Study* (World Bank, 1992), 34

- First, “China’s economic opening followed a change in the country’s supreme leadership. It was only with the consolidation of power by Deng Xiaoping that the move toward markets commenced.”
- Second, “Beijing’s leadership has indicated its confidence not only in the permanence of its new approach to trade but also in its ability to withstand the destabilizing turbulence unleashed by increased contacts with citizens from the state with which it is locked in a battle for legitimacy.”
- Third, “China’s rulers embarked upon relaxation of direct administrative controls over interactions with the international economy almost at the outset of the process of economic opening.”²⁰⁰

The counter-argument is striking and clearly evident. In North Korea, no change in leadership is envisioned or expected. If anything, Kim Jong-il has entrenched his grasp since his father’s death in 1994. Contact with South Korea has expanded since 1991, and even more so since the 2000 summit, but is still closely apportioned. An influx of societal contact with the South, regardless of the means, would be closely countenanced. And finally, the DPRK has given no indication that it wishes to relinquish control over any aspect of the economy, internally or externally.²⁰¹

The economic reform example set by China should impress upon the Pyongyang leadership that a system-level reform effort in North Korea is not only possible, but also predictably successful. China’s economic growth following the reform movement set a global record for doubling per capita output in the shortest period, accomplishing the feat in only ten years, 1977-1987.²⁰² By 1992, China, based on the World Bank’s estimates of purchasing-power-parity, became the world’s third largest economy, up from a rank of near 30 just twenty years earlier.²⁰³ However, China’s reform movement has come with social and domestic problems, which present the greatest obstacle for the North Korean regime in regard to economic reform. Nevertheless, China has moved forward economically with systematic reforms of its economic policy and is now facing the social

²⁰⁰ Eberstadt, *The End of North Korea*, 81-82.

²⁰¹ Eberstadt, *The End of North Korea*, 81-82.

²⁰² Kim, “The Future of the Post-Kim Il Sung System in North Korea,” 43.

²⁰³ Kim, “The Future of the Post-Kim Il Sung System in North Korea,” 43.

consequences which it vows to attend to with a large focus, all the while maintaining continuity within the leadership structure.

A major difference between China and North Korea, with regard to leadership, is the difference in philosophies, ability, and timing. The post-Mao leadership in China, led by Deng Xiaoping, is not comparable to the post-Kim Il-sung leadership in North Korea, led by Kim Jong-il. The timing of the change in leadership in China helped spur the reform movement largely because it was at the height of the Cold War and the reflective anti-Soviet sentiment helped support China's acceptance into the world economy. Today, North Korea is treated at arms length by most world leaders and continues to align itself with countries usually regarded as rogue and dangerous. At the time of the reform movement in China, the leadership was confronted with following ten years of social degradation at the hands of the Cultural Revolution, which made any hint of reform extremely popular. Deng, as quoted below, made use of this opportunity with which to announce and legitimize economic reform and opening to the global market.

“To accelerate China's modernization we must not only make use of other countries' experience. We must also avail ourselves of foreign funding. In past years, international conditions worked against us. Later, when the international climate was favorable, we did not take advantage of it. It is now time to use our opportunities.”²⁰⁴

North Korea, on the other hand, continues to staunchly voice its adherence to the *Juche* philosophy of self-reliance. All efforts to begin invoking reform have both failed and been abandoned, or have not received the proper support and attention needed to succeed. The North also has made little or no effort, aside from pleas for food and aid, to reach out and invite the world in as China did and continues to do.

²⁰⁴ Kim, “The Future of the Post-Kim Il Sung System in North Korea,” 45.

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VIII. CASE STUDY: VIETNAM

In the 25 years since the end of the Vietnam War, Vietnamese society, economy, and polity have been remade several times. Vietnam, once ostracized by its neighbors and the world community for attempting to spread its hegemony to neighboring Cambodia, has forsaken its Stalinist planned economy, ended its costly foray into Cambodia, embraced its neighbors by joining the Association of South-East Asian Nations (ASEAN), normalized relations with the United States, and reintegrated into the global capitalist system. Yet, like China, Vietnam remains a communist state.

Reforms during the 1980s took Vietnam from a planned economy to a market economy, creating a mixed system that ended the economic crisis. When the economy started turning around, Hanoi again tried to implement a command economy throughout the country. Further domestic resistance (especially from the peasants), the strains of war in Cambodia, and the potential loss of Soviet patronage all led the Communist Party to reverse its policies and begin its vaunted *Doi Moi* (“renovation”) program in late 1986. Originally envisioned as a program of gradual economic and political reforms, local accommodations and the actions of state-owned enterprise (SOE) managers transformed *Doi Moi*. By the end of the decade, the command economy had been scrapped in favor of a capitalist market that increasingly integrated into the global system.

During the 1990s economic reforms accelerated in return for continued communist political control. To replace the massive assistance lost when Soviet communism collapsed, Vietnam turned to its Asian neighbors, the United States, and the international marketplace. Once open to the world, the forces of internationalization began to influence Vietnam’s economic development.

A. TRANSITION TO THE MARKET

Hanoi entered the 1980s in the midst of grave crises that challenged Communist party rule. Southern resistance to the collectivization of agriculture and industry, along with peasant resistance nationwide, further forced the first generation of Vietnamese communist leaders into compromise reforms. These 1979 reforms ameliorated the food

crisis by slowing the expansion of the Marxist-Leninist command economy nationwide. Although partially successful, the 1979 reforms did not correct Vietnam's economic problems. Incentives at the local level to accommodate practical work-arounds, family-based agricultural production and additional "fence breaking," made the broken economy work. The interaction of grassroots work-arounds with periodic attempts by Hanoi to clamp down on the free market generated new rules of the game, allowing unplanned activities to become legal.²⁰⁵ In a similar vein, state employees were forced to create their own work-arounds by increasingly turning to the market for food and extra wages to offset scarcities, lost subsidies, and galloping inflation. All of this unofficial activity created a de facto commercialization of the economy that further reduced the monopoly power of the state.²⁰⁶

In response, a new system of enterprise management was announced in January 1981. Called the "three plan system," it merged the conventional planned economy with some of the elements of fence breaking. A SOE was allowed in essence to operate on three levels ("plans"). Plan A production was the old Marxist-Leninist plan – SOEs used state subsidized inputs to produce their quota of outputs sold at a low price to the state distribution system. Plan B allowed the SOE to acquire additional inputs on its own and to sell production above quota in order to pay for the unplanned inputs. Plan C allowed the SOE to diversify into new unplanned products to meet untouched consumer demand. Since the inputs for this diversified production came from the market, Plan C production was unregulated, but state trading companies were given priority in disposing the new production.²⁰⁷ Units outside the state system – private enterprises and collective artisan producers – were allowed to contract for production using a system similar to the agricultural product contract system. In addition, enterprises were given the option to adopt a piece-rate system for employee wages to spur labor productivity.²⁰⁸

²⁰⁵ Fforde, Adam and Stefan de Vylder. *Vietnam -An Economy in Transition* (Stockholm: Swedish International Development Authority, 1988), 61-2.

²⁰⁶ Fforde, Adam and Stefan de Vylder. *From Plan to Market: The Economic Transition in Vietnam* (Boulder, CO: Westview Press, 1996), 136.

²⁰⁷ Le Trang, "Renewal of the Industrial Management Policy and Organisation," in *Doi Moi: Economic Reforms and Development Policies in Vietnam*, ed. Per Ronnis and Orjan Sjoborg (Stockholm: Swedish International Development Authority, Stockholm School of Economics, and Central Institute for Economic Management; 1990), 159.

²⁰⁸ . Fforde and de Vylder, *Vietnam*, 68-9

In early 1983, steep taxes were levied on private enterprises deemed inessential, causing many to close or be taken over by the state. A new agricultural tax system was also introduced that favored collectives with lower fixed rates on yields. In an attempt to end fence breaking, Hanoi again required enterprises to buy and sell through state organs. The agricultural collectivization drive, held in abeyance since 1979, was resumed, with a new goal of complete collectivization by the end of 1985.²⁰⁹ However, as the decade progressed the state became increasingly involved in this process, cut subsidies, and dramatically raised wages and prices. Vietnam financed these policies by ever widening deficits, touching off high inflation. Meanwhile, the Hanoi tried to gain greater control over the retail market and private capital accumulation by introducing currency reform; creating a new dong (equivalent to 10 old dong) and severely limiting the quantity of old currency, which could be converted.²¹⁰ This led to greater shortages of consumer goods at the same time that workers had been given significant raises – precipitating hyperinflation.²¹¹

1. Doi Moi

In December 1986, Vietnam began in earnest its transition to the market. At the micro level *Doi Moi* adopted many of the innovations that Mekong delta family farmers, Red River cooperatives, fence-breaking managers, entrepreneurs, and their local cadre partners had been using to work around the problems of the central planning system. At the macro-level, the reforms were facilitated by shifts in regional and global balances of power, as well as in Vietnamese society. Foreseeing an end to Soviet aid, unwilling again to become a Chinese vassal, and unable to attract Washington as a new patron, Hanoi was forced to look to its Asian neighbors and the international market for capital, creating a new major class of stakeholders for reform, foreign capitalists.

In early 1987, significant free market and private enterprise concessions were made in Ho Chi Minh City, Hanoi, and other areas. Internal customs posts were closed in order to improve the flow of goods. At several party plenums, liberal ideas were codified

²⁰⁹ Beresford, “Dismantling the ‘Bureaucratic Centralism and Subsidy System,’” 219.

²¹⁰ Beresford, Melanie. *Vietnam: Politics, Economics, and Society* (London and New York: Pinter Publishers, 1988), 169.

²¹¹ Beresford, “Dismantling the ‘Bureaucratic Centralism and Subsidy System,’” 115.

into policies on foreign investment, land tenure, foreign trade, foreign investment, industrial management, the private sector, the family sector, etc.²¹² Unfortunately, the economy failed to respond quickly to the reforms, and by late 1987 a sharp drop in agricultural staples output caused further deterioration.

In April 1988, Hanoi shifted most production management from the collective to the household. Collective lands countrywide were to be divided up between families, who were given responsibility for the entire production process. The more productive farmers were to be allocated additional land. A new contract system was established with fixed five year terms and a guarantee that the families could keep at least 40 percent of the contracted yield. Acquisition of inputs and services from sources outside of the collective was legalized, and families could hire seasonal labor on a negotiated basis. Prices of all inputs and outputs were also to be negotiated – signaling an official turn towards the market. Tax concessions were made so as long-term crops and forestry resources were not taxed until harvested. The cooperative was to be transformed into a service entity – retaining ownership of irrigation equipment and other resources that would benefit all the families in the area, providing agricultural extension and social services, and helping to insure access to credit.²¹³

Hanoi also began to modify the “three plan system” of state enterprise management making firms more market sensitive. Under the new reforms, centrally planned control was de-emphasized, and Hanoi began to refer to itself as the “manager” of the economy. As manager, the state began to establish the independence of economic units from the administrative system. The first major change was adopting the capitalist definition of profits as revenue less real costs, instead of the socialist definition as a planned percentage markup over approved input costs.²¹⁴ Other decrees began to slowly dismantle the state planning system by consolidating ministries, reducing central control, eliminating subsidized inputs and planned production for most enterprises. Instead of planned quotas and profit targets, these enterprises were given tax targets.²¹⁵

²¹² Fforde and de Vylder, *From Plan to Market*, 145.

²¹³ Fforde, “Major Policy Changes and Socio-Economic Development in Vietnam Since Mid 1988,” in Doi Moi, eds. Ronnb and Sjoberg , 10-1.

²¹⁴ Fforde and de Vylder, *Vietnam*, 84-5.

²¹⁵ Fforde and de Vylder, *From Plan to Market*, 157.

With commercialization came the need for capital. There were two significant changes that gave birth to capital markets and the loosening of state control over credit. The first was a new foreign investment law promulgated in December 1987, and the second was the development of a new State bank and commercial banks in 1988 and a substantial shift to self-financing by state enterprises.²¹⁶ The latter recognized the credit creation aspect of fence breaking, while the former met some of the credit need with new, more enterprise-friendly banks. The 1987 law, on the other hand, allowed for up to 100 percent foreign ownership, as compared to 49 percent under the 1977 law, remittance of profits, and repatriation of capital after sale or liquidation subject to a remittance tax.²¹⁷

2. The End Of The Cold War

Many events came together in 1989 to change the world. Vietnam was deeply affected by the collapse of communism in Eastern Europe and decay within the Soviet Union. Shocked that fraternal communist parties could not control the events let loose by glasnost and perestroika, the Vietnamese Communist Party (VCP) began to look at its own policies.²¹⁸ The last major element of the planned economy was demolished in March 1989, when Hanoi accelerated price reforms by abolishing the “two price system” of official business prices and free market prices in order to stem resurgent inflation. At the same time, the borders were opened, and high-quality imported consumer goods (mainly from China and Vietnam’s Southeast Asian neighbors) began to flood into the country. With the exception of a few social items such as electricity, housing rents, medicines, and a few others, state subsidies were dropped. Markets generally shifted into supply and demand balance, and Vietnam’s capitalist system was reborn.²¹⁹

While Vietnam was accelerating economic change, it was also embarking on an ambitious new foreign policy. As Moscow openly courted Beijing, Hanoi had little choice but to improve its relations with its large northern neighbor as well.²²⁰ As a gesture of goodwill, Vietnam hastened its withdrawal from Cambodia, claiming that all

²¹⁶ Fforde, “Major Policy Changes and Socio-Economic Development,” 9.

²¹⁷ Socialist Republic of Vietnam, *Report on the Economy of Vietnam* (Hanoi: United Nations Development Program, 1990), 13 1-3.

²¹⁸ Thayer, “Doi Moi and the Emergence of Civil Society,” 117.

²¹⁹ Fforde and de Vylder, *From Plan to Market*, 177-8.

²²⁰ Frost, 33.

troops had left by the end of September, a full three months earlier than promised. Concurrently, Hanoi lobbied to improve relations with its ASEAN neighbors, Taiwan, Japan, and the United States in the hope that improved ties would lead to increased aid and investment.

B. THE MARKET AND COMMUNISM

By 1990, the mixture of policies adopted by a weak Hanoi in response to strong domestic and international pressures for liberal economic reform led to a dramatic reinvention of the economy. Totally unprepared, the communist party leadership found itself in the awkward position of governing a capitalist economy, albeit one with several distortions that were vestiges of the defunct planned system. While professing the importance of the household farm and small private enterprise to the new Vietnam, Hanoi stuck to the Stalinist preference for SOEs and industrial development. State credit policies were also skewed in favor of the SOEs, much to the detriment of the countryside where over three quarters of the population live. Nonetheless, agricultural growth has been rather strong. The impressive gains in agricultural productivity – around 4 percent per year – came almost solely from family savings and reinvestment.²²¹ At the same time shifts in the global and regional balances of power left Hanoi without its superpower patron. Hanoi's need to replace Soviet aid with foreign capital drove a policy of reconciliation with its ASEAN neighbors, China, and the United States.²²²

1. Losing Soviet Support

In 1990 Moscow informed Hanoi that aid would be cut drastically in 1991 and that all commercial relations would be conducted in hard currency at world market prices. As the Soviet Union imploded in 1990, Moscow was unable to meet its commitments to provide vital supplies, such as petroleum, oil, steel, and cotton, severely hampering Vietnamese industry. Meanwhile, Soviet enterprises backed out of between 20 to 60

²²¹ Fforde, "Dyed-in-the-Wool Tigers?" 6.

²²² Beresford, "Dismantling the 'Bureaucratic Centralism and Subsidy System,'" 222-3.

percent of their contracts to purchase Vietnamese textiles, clothes, shoes, handicrafts and light industrial products. In turn, Vietnam defaulted on over a quarter of its contracts.²²³

As a result of the long expected break, unemployment and inflation increased. Shortfalls in the supply of Soviet fertilizer caused a drop in rice production and a doubling of the market price. Oil and steel prices tripled. When Moscow demanded that Vietnam pay dollar salaries for all of the Soviet experts and technicians in the country, Hanoi balked and Moscow began to pull them out, nearly halving their number by mid-1991. Trade with the Former Soviet Union dropped dramatically - from a high of over 60 percent of total Vietnamese foreign trade in the 1980s to 50 percent in 1990 and 14 percent in 1991.²²⁴ At the end of 1991, the International Monetary Fund estimated that the loss of Soviet and East European aid amounted to 7 percent of Vietnamese GDP.²²⁵

2. Embracing China, ASEAN, And The United States

To make up for these dramatic losses, Hanoi scrambled to improve relations with its neighbors. Yet, even though Hanoi had withdrawn its troops from Cambodia in September 1989, Vietnam was still blocked by the United States-led international embargo from rapprochement with ASEAN and China. In July 1990 the United States announced it was dropping its support of the coalition in Cambodia and was willing to negotiate with Vietnam for peace in the region, Hanoi now had the opening it needed to patch up in short order differences with its neighbors. Secret meetings with the Chinese leadership in September 1990 led to normalization in November 1991.²²⁶ ASEAN's anti-Vietnam stance soon crumbled after Indonesia normalized relations in November 1990.²²⁷ Rapprochement with the other five ASEAN states quickly followed. French observers Jean- Claude Pomonti and Hugues Tetrais noted:

“The reorientation of Vietnamese diplomacy, brutally cut off from Soviet support, was radical...the turn-around – and what a turn-around –

²²³ Thayer, “Russian Policy Toward Vietnam,” in *Russian Foreign Policy Since 1990*, ed. Peter Shearman (Boulder, Colo.: Westview Press, 1995), 213.

²²⁴ Thayer, “Russian Policy Toward Vietnam,” 167.

²²⁵ IMF, *Vietnam - Recent Economic Developments* (Washington, D.C.: International Monetary Fund, 1991), 1.

²²⁶ Denny Roy, *China's Foreign Relations* (Lanham, Md.: Rowman & Littlefield, 1998), 194.

²²⁷ Singh, 222.

occurred in the space of one year. Vietnam's integration into regional economic relations took place much more rapidly than anyone could have dreamed, as if once it started, there was no way to stop it.”²²⁸

Vietnam's rapprochement with its neighbors paid real dividends. Total approved FDI grew from \$366 million in 1988 to over \$1.9 billion in 1992, with over one sixth of the funds coming from ASEAN states.²²⁹ By 1996, ASEAN accounted for 40 percent of FDI.²³⁰ Vietnamese-ASEAN trade grew from a meager \$86 million in 1988 to more than \$2.6 billion in 1992 to approximately \$5 billion in 1997 – 6.5 percent, 31 percent, and 30 percent respectively of Vietnam's trade.²³¹ Trade with China also skyrocketed after the border was opened in late 1988. From an estimated \$10 million in 1988, Sino-Vietnamese trade increased after normalization of relations to \$584 million, or 8.8 percent of total Vietnamese trade, in 1992 and about \$1 billion in 1995, or 9 percent of total trade.²³²

Vietnam formalized its ties to ASEAN by becoming a full-fledged member in 1995, bringing the organization full circle from being a predominantly anti-Vietnam association of Southeast Asian capitalist economies to being a truly regional economic confederation. It also symbolized Hanoi's reintegration into the global marketplace. With the accession of Laos in 1997 and Cambodia in April 1999, Vietnam too went full circle, becoming, instead of the local hegemon, an equal partner with the rest of Indochina in ASEAN.

Securing American partners to balance against Chinese interests in the disputed South China Sea was not the only dividend of improved relations with the United States. Washington's support was also crucial to Hanoi for obtaining needed international development assistance. IMF, World Bank, and Asian development Bank projects were put on hold in the 1980s when the U.S. Congress threatened to withhold American contributions if the international organizations continued to aid Vietnam after its invasion of Cambodia. Hanoi subsequently defaulted on IMF loans, making future aid nearly

²²⁸ Pomonti and Tetrais, 142.

²²⁹ John R. Dodsworth, et. al., *Vietnam: Transition to a Market Economy* (Washington, D.C.: International Monetary Fund, 1996), 18.

²³⁰ Chang Pao-min, “Vietnam and China: New Opportunities and New Challenges,” *Contemporary Southeast Asia* 19, no. 2 (September 1997): 148.

²³¹ “Vietnam-ASEAN Trade Ties Develop Rapidly,” *Vietnam News Agency*, 7 December 1998.

²³² Institute of Southeast Asian Studies, *Regional Outlook: Southeast Asia, 1996-97* (Singapore: Institute of Southeast Asian Studies, 1996), 59.

impossible. In July 1993 the United States dropped its opposition and the IMF, World Bank, and Asian Development Bank followed by planning to release over \$885 million for approved infrastructure projects.²³³

Although Hanoi had made great strides in getting Washington to drop American opposition to aid and the longstanding economic embargo, its efforts were incomplete until it could establish diplomatic relations with Washington. For Hanoi, American recognition was an important emblem of the new Vietnam's successful integration in the world system. In July 1995, President Clinton finally felt that he had sufficient support from the business community and other interested parties to overcome the opposition of many conservatives and veterans for the normalization of relations. The process was completed in 1996 with the establishment of embassies in the two capitals and the exchange of ambassadors.

3. The Asian Economic Crisis

Compared with its Southeast Asian neighbors, especially Thailand and Indonesia, Vietnam has weathered the Asian economic crisis rather well. Unlike the deep recession that faced Thailand, Malaysia, Indonesia, and South Korea, Vietnam experienced a relatively slight contraction. The major reasons were a relatively stable currency, a high degree of confidence in domestic banks, and the lack of an open capital market.²³⁴ After turning the economy around in the early 1990s with the assistance of massive foreign aid and investment, Vietnam was enjoying an average annual growth of between 8 and 9 percent before the crisis.²³⁵ Poverty was down by a third between 1986 and 1996.²³⁶ Exports grew even faster, but still were not approaching the high levels of imports, causing a large trade deficit that became a brake on the economy as other aspects of the regional crisis began to be felt.²³⁷

²³³ Susumu Awanohara and Chanda, "Foreign Relations: The Wages of Peace," *Far Eastern Economic Review*, (15 July 1993), 10-1.

²³⁴ Fforde, "Dyed-in-the-Wool Tigers?" 6-7.

²³⁵ Raymond Mallon, "Doi Moi and Economic Development in Vietnam: A Rapid Overview of a Decade of Reform." in *Doi Moi*, ed. Fforde, 11-2

²³⁶ Ari Kokko, "Vietnam: Ready for Doi Moi II?" *ASEAN Economic Bulletin*, 15, no. 3 (December 1998): 320.

²³⁷ Awanohara, "Borrowing: Open the Floodgates," *Far Eastern Economic Review* (7 October 1993), 92-3.

With the advent of the Asian crisis, Vietnamese growth fell off sharply to an estimated 3 to 5 percent in 1998.²³⁸ Exports dropped for the first time in many years. Manufacturers who were producing low cost goods for sale in the region found their market dry up. Tourism fell to a trickle. Government revenues were also down and SOEs were wracking up higher losses, causing Hanoi to postpone several large infrastructure projects.²³⁹ Unemployment jumped to an official 6 percent, but more likely much higher as SOEs began to lay off employees.²⁴⁰ Weakness in Japan, Korea, Hong Kong, Thailand, and Indonesia adversely affected both FDI and development aid flows (both from regional and international sources). Realized FDI in 1998 was down over 50 percent from the year before, while new investment - predominantly Asian in the past - nearly ceased, falling 60 percent in the first ten months of 1998 after having fallen 50 percent in 1997.²⁴¹

C. LESSONS LEARNED

Vietnam is a poor, densely populated country that has had to recover from the ravages of war, the loss of financial support from the old Soviet Bloc, and the rigidities of a centrally planned economy. Substantial progress was achieved from 1986 to 1996 in moving forward from an extremely low starting point – growth averaged around 9 percent per year from 1993 to 1997.²⁴² The 1997 Asian financial crisis highlighted the problems in the Vietnamese economy but, rather than prompting reform it reaffirmed the government's belief that shifting to a market oriented economy leads to disaster.

Rapprochement with the capitalist West and Asia paved the way for the growing influence of internationalization on the Vietnamese economy. Foreign investment – mainly in joint ventures with SOEs – became a major force in the economy, accounting for nearly one-third of all industrial output in 1998.²⁴³ With the foreign funds came increased pressure to liberalize the economy, as investors pushed for more transparency, legal reform, and administrative reform.

²³⁸ Fforde, “Dyed-in-the-Wool Tigers?” 5.

²³⁹ Faith Keenan, “Vietnam: Reality Check,” *Far Eastern Economic Review*, (3 September 1998), 57.

²⁴⁰ Kokko, 325.

²⁴¹ Kokko, 323-4.

²⁴² “Background Notes: Vietnam” U.S. Department of State, Bureau of East Asia and the Pacific Affairs (February 2002), http://www.state.gov/www/background_notes.

²⁴³ Kokko, 301.

While Vietnam and U.S. companies welcomed normalization of economic and political relations, it did not produce the American investment flows that Hanoi desired. Vietnam's endemic corruption, inadequate laws, bureaucratic red tape, and the Asian economic crisis have kept American investment relatively low, especially compared to the funds coming from Vietnam's overseas Chinese connections.²⁴⁴

The largest concern during the reform movement has been regime survival. The biggest threat to the regime is a wellspring of discontent among those who feel they are being bypassed by Vietnam's economic growth. The population has accepted the premise that "first that the economy will perform better under a market regime that it did under central command, and second that improved performance will translate into measurable improvements in consumption and living standards."²⁴⁵ What the Vietnamese have not accepted is the widespread corruption, which unfairly enriches the local cadres and their families. Regardless, as long as the party delivers on an improved economy and lifestyle, the population seems to tolerate party rule. Former British Ambassador to Vietnam Derek Tonkin explains.

"There is a concordat between the Party and the population that the Party will govern with a light touch of the reins and without cracking the whip, while the people have something of a heyday in seeking material improvement after so many years of struggle and sacrifice."²⁴⁶

Even the poorest farmers claim that life now is better than it was during the hardships of war and reunification. The only major complaints of the masses seem to be anger over corruption at the local level.

1. Similarities to Korea

For Vietnam, an indicator of the success of economic reform was the existence of a large, labor-intensive agricultural sector. De-bureaucratization of agriculture permitted rapid increases in productivity and the release of labor into the emerging non-state owned manufacturing sector. The farmers' incomes went up as marginal and average value

²⁴⁴ Dodsworth, et al., 18.

²⁴⁵ D. M. Leipziger, *Awakening the Market: Vietnam's Economic Transition* (Washington, D.C.: the World Bank, 1992), 30.

²⁴⁶ Derek Tonkin, "Vietnam: Market Reform and Ideology," *Asian Affairs* (London) 28, part 2 (June 1997): 194.

product in the agricultural sector increased. The incomes of those leaving the farms rose as they receive higher wage jobs in the manufacturing sector and urban workers in the state-owned heavy industry sector benefited as their real wages rose as a result of lower food prices. The efficiency gains in agriculture essentially financed an economy-wide improvement. North Korea, however, has only about half the share of its labor force engaged in the agricultural sector (33 percent), as did Vietnam (71 percent) at the time that they commenced reforms. In terms of its composition of output, North Korea more closely resembles parts of Eastern Europe or the former Soviet Union than it does Vietnam when they initiated reform.²⁴⁷

In comparison to Vietnam, the more industrialized character of the North Korean economy and the apparent loss of control by the central planners suggest that reform is more likely to be a relatively more chaotic process. The counter is that the North Korean economy has sunk so far that incumbent enterprises, workers, and elites will accept any reform as potentially welfare-enhancing. In any event, it appears that the regime retains considerable coercive powers and capacity for suppressing dissent. The most successful outcome, at least as measured as contributing to long-term regime stability, would be the successful implementation of economic reform. The example of Vietnam has demonstrated the possibility of introducing reforms into centrally planned economies while maintaining regime stability for extended periods of time. The process of internal change could be reinforced by positive external developments that would support this process politically and financially.²⁴⁸

Nonetheless, there is growing evidence that North Korea is beginning to undertake some economic reform measure similar to those experienced in Vietnam. It is reported that North Korea has reduced the size of agricultural production teams from 10-24 persons to 5-7, slightly larger than the average size of one household. The production teams are also granted more discretionary power in selecting the type of product to grow in light of comparative advantage, which certainly means a weakening of central planning. Moreover, the North Korean regime has substantially reduced production

²⁴⁷ Kim, Samuel S. ed. *The North Korean System in the Post-Cold War Era* (New York: St. Martin's Press, 2001), 245.

²⁴⁸ Kim, *The North Korean System in the Post-Cold War Era*, 255.

quotas for rural areas, and any outputs above the quotas are left with the producers to dispose of as they please.²⁴⁹

Similar changes are taking place in North Korean industry. As was the case in Vietnam during its initial stage of reform, North Korea is now expanding enterprise autonomy by decentralizing decision making to the basic unit and top managers, who are sometimes elected by the workers. Now the North Korean regime encourages the industrial enterprises to seek practical benefits and must be in the process of devising more powerful incentive schemes for the basic units and its staffs and workers. This is an important part of the effort to expand the vocabulary, concepts, and ideas of the market economy. It is also reported that the North is attempting to successfully restructure its legal framework to attract more foreign investment, which along with the growing effort to renew or begin diplomatic ties with a large number of countries, shows significant proof that the North Korean regime has the potential to reform, but in many ways lacks the ability. This is because of a lack of education and exposure, of which the South could easily supply.²⁵⁰

²⁴⁹ Hong Yung Lee, "Kim Dae-Jung's Sunshine Policy and Breakthrough on the Korean Peninsula." in *Korea: Dynamics of Diplomacy and Unification*, Monograph Series, Number 12. ed. Koh, Byung Chul, (Claremont McKenna College: Keck Center for International and Strategic Studies, 2001), 107.

²⁵⁰ Hong Yung Lee, 108.

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IX. CONCLUSION

“The final failure of the North Korean state is not something that external actors could forestall, even if they were so inclined. But the manner in which the DPRK departs can be influenced, and how it departs world politics matters greatly, both within Korea and beyond.”²⁵¹

- Nichols Eberstadt

A. SOUTH KOREA

With the clock winding down on Kim Dae-jung’s leadership in South Korea, his legacy is squarely in the hands of Kim Jong-il. A reciprocal visit by the North’s leader to Seoul has been promised since the historic June 2000 summit, but issue upon issue has aided in its never coming to fruition. Already heavily politicized domestically, President Kim may create a political firestorm if he concedes too much to the North in order to assure a legacy-establishing summit in Seoul before his term ends. Further politicizing the issue, the December 2002 presidential election will put a spotlight on the South’s policies toward the North. This will further intensify domestic debate and drive a deeper wedge between the various schools of thought, playing into the hands of Pyongyang. Political instability is not unfamiliar to the South, but it does create an environment for the North to cling to its tactics of regime survival.²⁵²

Thus, public disagreement over the policy of engagement is largely the result of the inter-Korean relationship being at a crossroads. There still exist two very conflicting elements in the minds of many: hostility toward North Korea and yearnings for unification. The result is a divided public with some still clinging to the Cold War era psychology and others with a new mindset of the post-Cold War world. This division will lead the public to use different yardsticks. The truth is that the existence of diverse views about North Korea is never harmful, and to some extent an inevitable phenomenon. South Korea itself is undergoing a transitional period, leaving behind the old relationship of confrontation and moving towards one of unity and cooperation.

²⁵¹ Eberstadt, *The End of North Korea*. 117.

²⁵² Levin and Han, xii.

The effect of this public debate is the birth of a new sense of convergence among liberals and conservatives within the national debate. It will hopefully bridge the gap in views of North Korea and filter the extremist voices out of the debate. The radical sentiment among some college students and workers has significantly diminished in public debates. In addition, a large number of people with conservative background have begun entertaining the thought of visiting North Korea, a sign of growing acceptance of North.

B. NORTH KOREA

Can the North be trusted as a business partner? North Korea has failed to honor almost all of the commitments it has agreed to in accordance with the June 2000 Joint Declaration. Its erratic behavior has called into question its willingness to come to terms with South Korea more broadly. Above all, the North has made no effort to discard its ambition to unify the Korean peninsula under North Korean terms. The North's strategy still supports its traditional united front to undermine the ROK government.²⁵³

In fact, North Korea's approach continues to remain essentially offensive in nature. The military continues to receive the overwhelming priority, despite miserable economic conditions. By doing so, the North is maintaining its long-term goal of unification on North Korean terms and the short-term goal of providing security for the preservation of the North Korean regime. Although assured mutual South Korean response, the North continues to refuse to reduce its military posture, which would allow a diversion of resources to more pressing needs.²⁵⁴

North Korea has been showing signs of change since 1990, when the country was experiencing enormous economic difficulties, including severe shortages in energy, food and foreign currency. Its people began wandering in search for food, while others risked their lives to cross borders to survive. Economic improvement soon became a top policy priority, with the regime openly seeking contacts with the outside world in search of foreign aid as well as investments. The food shortage, paradoxically, also served as a

²⁵³ Levin and Han, 33.

²⁵⁴ Levin and Han, 37.

factor for change because famine made North Koreans more inclined to favor any system that could provide daily necessities over their traditional system of rationing.

On the diplomatic front, the North has been seeking a similar transformation. While it sought to maintain friendly relations with traditional allies such as China and Russia, it has also sought to open itself up to the international community and build better diplomatic relations with the outside world. Its participation in the ARF (ASEAN Regional Forum) reflects the North's effort to improve its image on the international stage.

Moreover, the North has become more active than ever in reaching out to the world to learn about capitalism and the market system. Last year alone, Pyongyang dispatched as many as 500 of its scholars and officials to the United States, Europe and elsewhere, in hopes of acquiring the skills needed for a market economy, particularly in the areas of international economics, financing, trade and accounting. The North's pace of transformation has slowed in the aftermath of September 11th and the subsequent anti-terrorism campaign. In view of North Korea's long-held rigidity and policy of isolation, signs of transformation should neither be taken for granted nor dismissed as insignificant.

C. UNITED STATES

The U.S. goals in Korea are not always necessarily the same as the Korea's. In that vein, the United States has not invested economically in North Korea, nor has it wholly adopted the principles of Roh's "Nordpolitik" or Kim's "Sunshine policy." The United States is, and has been, one of the South's largest investors and trading partners. The North, aside from its socialist system, is not an attractive economic investment for American businessmen. The North's human rights record and sponsorship of terrorism and weapons of mass destruction have caused the United States to label them an enemy and thereby impose economic sanctions upon them. Regardless, the possibility of Korean economic integration and joint ventures across the DMZ could be a building block to ease American tensions, revise its sanction policies, and attract U.S. investment.²⁵⁵

²⁵⁵ Olsen, 19-21, 37-38.

D. GERMANY AND YEMEN

A slow, careful approach to reducing tension and increasing ties between the two Koreas is needed to provide time for a more complete integration of the two societies prior to full unification. Such an approach could mitigate the impact of some of the more socially disruptive and economically costly aspects of the unification process. After unification, Korea will be preoccupied internally. All available capital will be channeled into reconstructing the threadbare North. The daunting task of infrastructure investment and industry retooling will take years. As the cases of Yemen and Germany show, a more deliberate economic union and integration prior to unification will ease many of these burdens.

Although much can be learned from both German and Yemeni unification, there are some characteristics unique to Korea that will affect a smooth unification, although not all will do so in a negative manner. These include limitations on foreign investment, relatively large military forces (both in size and level of expenditure), and the relative difference between the size of the North and South's populations and economies.²⁵⁶ However, these obstacles are not insurmountable, but will take a considerable amount of effort to overcome.

If the Yemeni case reveals anything, it is that if two diametrically opposed political and economic systems persist into unification, the friction that exists between them will at best severely hamper the effort, or worse, lead to violence. On the other hand, Germany may have successfully avoided such an outcome because the East German population clearly saw communism for the economic failure it was. Admitting economic failure will have to take place in North Korea in order to begin implementing market-based reforms as part of an incremental economic union.²⁵⁷

Additional factors that are unique to Korea are likely to make the process more complex and difficult than that experienced by either Germany or Yemen. While ideological differences may give rise to fears of a Yemeni-like "divorce" following a hasty unification, strategic impediments and major power support for a peaceful process

²⁵⁶ Dahlman and Andersson, 4.

²⁵⁷ Yu, Yong-ju, "Changes in the Korean Economy Four Years after the IMF Bailout and its Future Tasks," *Samsung Economic Research Institute*, Issue Report No.206, (1 Dec 2001)

are likely to overcome any such tendencies. The stakes are too high to allow Korea to spiral into another civil war, which would be its last.

E. CHINA AND VIETNAM

At the time of the reforms in China and Vietnam, their economies were much more agrarian than North Korea is today. In 1978, 71 percent of the Chinese economy consisted of the agricultural sector. The same can be said of Vietnam in 1989. The North Korean economy, however, is heavily industrialized, with agriculture only making up about 30 percent of the economy. Because of the their large agricultural sectors at the time of adopting economic reforms, China and Vietnam were extremely successfully in their ability to shift extremely low productivity labor out of agriculture and into emerging non-state-owned light industry. North Korea, on the other hand, is a more industrialized economy, thus making reform efforts that much more challenging.

Furthermore, in China and Vietnam, the reforms were accepted easily and under relatively secure political and military conditions. In North Korea, the existence of a democratic and prosperous South Korea creates an enormous ideological challenge. Following the adoption of market reforms, the movement of people within the country to find work, and the realization that *Juche* was more of a failure than a success, would create social instability that may overwhelm the regime. Thus the North treats economic liberalization with extreme caution. Regardless, some studies predict that the North Korean economy would grow by as much as 50 percent within just a few years after economic reform.²⁵⁸

China and Vietnam are examples of gradualist economic reform. Because of the size and scope of the industrial sectors in each country, the reform strategy has thus far been successful, especially initially. Both countries were largely agrarian with very little heavy industry. Thus, the growth and increased standard of living that resulted from initial agricultural reforms provided a cushion to absorb some of the political turmoil of reform and in addition countered the erosion of political legitimacy. In North Korea, because of its centrally planned and heavily industrialized economy, the gradualist

²⁵⁸ Noland, "The Economic Situation in North Korea," 26-28.

approach would be an unsuccessful option.²⁵⁹ However, the reforms in China do provide a good analysis of what North Korea potentially faces.

F. UNIFICATION

With all the uncertainties inherent in the process of national reunification, and considering the high stakes involved in what may become a zero-sum game, it is understandable that the high ideal of national unity should be sacrificed or deferred. In short, reunification is highly desirable but it should not be attempted by force nor should it follow collapse. Moreover, Korean reunification, even a sudden unexpected one, would result in benefits as well as costs. Enlightened and foresighted policy could systematically augment those benefits.²⁶⁰

Nicholas Eberstadt points out the benefits, short term and long term, of reunification with a poorer partner.²⁶¹ It would:

- Help relieve South Korea's incipient labor shortage.
- Reduce pressures on wages and production costs.
- Enhance Korea's international competitiveness.
- Increase purchasing power and living standards for the majority.
- Generate dynamic supply side effects from newly installed capital stock.
- Replace decrepit northern facilities with state-of-the-art technology.

The last point alone would spawn lower production costs, enhance productivity, and stimulate the work force, thus laying the foundation for sustained long-term growth. Internationally, "the boom in domestic demand that would follow a successful Korean reunification would likely offer wide-ranging and lucrative business opportunities to all the Pacific powers."²⁶²

G. SUMMARY

In summary, one of the primary goals of a unified Korea is to create an economic union that has the potential to grow, provide, and lead. A unified Korea, with its diligent

²⁵⁹ Taylor, 223.

²⁶⁰ Eberstadt, *The End of North Korea*, 128.

²⁶¹ Eberstadt, *The End of North Korea*, 128-129.

²⁶² Eberstadt, *The End of North Korea*, 133.

work force, a highly educated population of 70 million, and a greatly reduced defense budget, would be a strong economic power, especially in sectors where South Korea already has a geographic and product advantage.²⁶³ South Korean *chaebol* are strong in the areas where many seek investment: construction, heavy engineering, automobiles, and consumer goods.²⁶⁴ The industries and firms of a unified Korea may also be freer from political considerations in trading issues than its leading rivals.²⁶⁵ In turn, there will be of greater advantage to Korean companies investing in the Far East as well as other global markets. A gradual and incremental economic union prior to a political unification will best create an environment conducive to this kind of economic success story.

The gradual and calculated economic integration of the Korean peninsula will be a long-term project that will require serious patience and perseverance. Nicholas Eberstadt points out that integration assumes “North Korea’s government will someday embrace a program of economic liberalization, and would somehow survive to complete the decades of transformation that such a program would entail.”²⁶⁶ As evident in its historical economic behavior, this conclusion seems remote at best for the current North Korean regime. However, a continued separate economic future will only widen the gap between the North and the South and further increase the possibility of catastrophe. Any delay in economic integration will also continue to increase the costs of unification, creating enlarged burdens for the South as the North further continues its economic decline.

The primitive economic condition in the North and the yawning social gap between the two peoples is a major impediment to the ultimate integration of the two systems. Building trust gradually through economic and humanitarian exchanges is a means for advancing both the short and long-term goals of peaceful coexistence and eventual unification.²⁶⁷ Since armament is the outcome of both external and internal processes, there is not much that can be done with the internal dynamics of North Korea. However, “a more practical approach would be to ‘buy peace’ in the literal sense of the

²⁶³ Noland, Robinson and Liu, 12.

²⁶⁴ Byung-Nak Song, 223.

²⁶⁵ Kim, *Korea's Globalization*, 163.

²⁶⁶ Eberstadt, *The End of North Korea*. 127.

²⁶⁷ Levin and Han, 9.

term, i.e. massive investment aid from the South, which would in the end bring about stability and reform in the North. Economic cooperation is the best ‘confidence-building measure’ of the South.”²⁶⁸

The scenario of gradual economic unification prior to political union provides a solution for unification that will allow South Korea to avoid many of the problems associated with the unification of Germany and Yemen. However, differences in culture, government, and people as well as the economy will necessitate different results. No model will be 100 percent accurate in predicting the complex interactions between the peoples and the integrated economy of North and South Korea.²⁶⁹ Albeit, the unification of North and South Korea seems to be an undisputed eventuality, at the current time Korean unification appears to be merely a noble but unrealistic goal for the immediate future.

²⁶⁸ Hamm, 166.

²⁶⁹ Hamm, 196.

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